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No. ____

IN THE

Supreme Court of the United States

MCDONNELL DOUGLAS CORPORATION and
GENERAL DYNAMICS CORPORATION,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

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PETITION FOR A WRIT OF CERTIORARI

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January 27, 2000

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QUESTION PRESENTED

Whether, in a decision that will govern virtually every contract dispute with the federal Government, the Federal Circuit should have departed from longstanding law – and the settled expectations of public contractors – when it held that the Government need not make a judgment on the merits of the propriety of a default termination prior to imposing that drastic sanction upon a public contractor?

LIST OF PARTIES

Pursuant to Rule 14.1(b) and Rule 29.6, the following list identifies all the parties to the proceeding before the United States Court of Appeals for the Federal Circuit:

McDonnell Douglas Corporation, appellee and cross-appellant below, is a wholly owned subsidiary of The Boeing Company. No publicly held company owns ten percent or more of the stock of The Boeing Company.

General Dynamics Corporation, appellee and cross-appellant below, has no parent corporation. No publicly held company owns ten percent or more of the stock of General Dynamics Corporation.

The United States.

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GENERAL DYNAMICS CORPORATION,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

PETITION FOR A WRIT OF CERTIORARI

McDonnell Douglas Corporation and General Dynamics Corporation respectfully petition for a writ of certiorari to review a judgment of the United States Court of Appeals for the Federal Circuit, which abandoned a longstanding procedural requirement of virtually all Government contracts that the Government must consider a public contractor's claims and defenses to a default termination before subjecting the contractor to that drastic sanction – a sanction that in this case could result in a cost forfeiture of over $2.5 billion.

OPINIONS BELOW

The opinion of the Federal Circuit, 182 F.3d 1319 (Fed. Cir. 1999), is reprinted at Pet. App. 1a-27a. The order of the Federal Circuit denying the petition for rehearing and suggestion for rehearing en banc is reprinted at Pet. App. 73a-74a.

The opinion of the United States Court of Federal Claims, 35 Fed. Cl. 358 (1996), holding that the termination for default could not be sustained, is reprinted at Pet. App. 28a-72a.

JURISDICTION

The Court of Appeals entered its decision on July 1, 1999. On September 15, 1999, petitioners timely filed a petition for rehearing and suggestion for rehearing en banc. Pet. App. 1a. On October 29, 1999, the Court of Appeals denied the petition and declined the suggestion. Pet. App. 73a-74a. The jurisdiction of this Court is properly invoked pursuant to 28 U.S.C. § 1254(1).

REGULATORY PROVISIONS INVOLVED

This case involves the Federal Acquisition Regulations governing the process of terminating a Government contract for default, 48 C.F.R. § 49.402-3, and the standard default clause, 48 C.F.R. §§ 52.249-8, -9. The pertinent portions of these regulations are reprinted at Pet. App. 75a -78a.

STATEMENT OF THE CASE

Background.

This case involves the Government's decision to terminate a multi-billion dollar research and development contract entered into between McDonnell Douglas Corporation, General Dynamics Corporation (collectively, "the contractors") and the United States in 1988. The contract involved an effort to extend stealth and related technology, which the Air Force was then using in its B-2 and F-117A aircraft programs, to a new attack airplane for the Navy that would operate from aircraft carriers. The contract envisioned that the contractors would design this new aircraft, called the "A-12," and produce eight test aircraft.

As is typical with major aircraft development programs, issues arose during performance of the contract, including difficulty meeting the contract weight specification as well as the original contract schedule. In 1990, the contractors informed the Government that the original contract requirements could not be met, but raised substantial issues regarding whether the contractors could be held responsible for their inability to meet the contract requirements. Specifically, the contractors asserted, among other claims, that the Navy had waived the original contract requirements during performance, that the Navy had failed to disclose its superior knowledge regarding stealth-related technology, that the Navy had imposed requirements that were impossible to achieve, and that the Navy had interfered with contract performance.

On January 6, 1991, the Office of the Secretary of Defense ("OSD") abruptly withdrew the funding for the A-12 program, the day before the Government was due to obligate $553

million to the contract. Although the contracting officer was "stunned" by this decision, he terminated the A-12 contract for default the following day. Pet. App. at 43a-47a. He did not consider the substantial claims that the contractors had made in 1990 that they were not in default. *Id.* at 52a ("The decision to terminate was made hastily without consideration of relevant facts."); *id.* at 46a ("Morris [the contracting officer] did not review any A-12 contract documents in preparation for the termination. He did not consult with technical personnel."); *id.* ("He did not review documents related to schedule or specifications."); *id.* at 55a ("He did not review the contractors' claims for equitable adjustments. He could not give adequate attention to the claims that may have excused the alleged defaults in that time, especially those involving superior knowledge issues."). The termination documents were riddled with errors, including references to contract requirements from a completely different aircraft program that were inapplicable to the A-12 contract. *Id.* at 44a-46a & nn.11-12.

Moreover, regardless of the reason that OSD withdrew funding (and even if it did so in part due to performance-related issues), *no one* in the Government made a judgment on the merits of the contractors' claims prior to terminating them for default. *Id.* at 57a ("Neither the Secretary of Defense nor anyone else in DOD exercised discretion in the process; no consideration of the contract's circumstances occurred.").

Proceedings Below.

The contractors challenged the default termination by filing this case in the Court of Federal Claims, pursuant to the Contract Disputes Act, 41 U.S.C. § 609, and 28 U.S.C. § 1491, seeking to convert the termination into one for the convenience of the Government. One of the bases for the contractors'

challenge was that the termination for default was procedurally improper. In this regard, the contractors asserted that they had not been afforded their contractual right to a reasoned judgment by someone in the Government – prior to the default termination – as to the merits of their claims that the Government was responsible for the performance issues under the contract.

After trial on this issue, the trial court ruled for the contractors. The trial court found as fact that "[t]he entire termination procedure was *pro forma* at best." Pet. App. 56a. Finding that no one in the Government made the judgment on the merits required by the contract's default clause, by the governing regulations, and by longstanding precedent, the trial court converted the termination for default to one for convenience. After further proceedings, the trial court found that the contractors were entitled to over $2.5 billion in costs they had reasonably incurred in performing this contract, costs that the Government sought to make them forfeit. This ruling meant that the contractors could retain approximately $1.3 billion in progress payments they already had been paid and that the Government had to reimburse them $1.2 billion for costs that had not yet been paid.

The United States appealed. In pertinent part, the Court of Appeals for the Federal Circuit reversed the trial court's conversion of the default termination and remanded for further proceedings. Pet. App. 1a-19a. The Court of Appeals held that, as long as there is some "nexus" between the Government's termination for default and performance issues under the contract, the Government need not consider the contractor's claims that it is not in default before subjecting the contractor to the harsh sanction of a default termination. Pet. App. 2a, 11a.

REASONS FOR GRANTING THE PETITION

This case presents an extremely important question regarding the process that is due a public contractor before the Government may impose upon the contractor the Government's extraordinary power unilaterally to terminate its own contractual obligations, and to do so for default. A default termination is a "drastic sanction" that "should be imposed (or sustained) only for good grounds and on solid evidence." *Lisbon Contractors, Inc. v. United States*, 828 F.2d 759, 765 (Fed. Cir. 1987) (internal quotation omitted). Previously settled law has long required the Government to make a reasoned determination on the merits as to whether a default termination was justified, including consideration prior to termination of any reasons or excuses for problems in performance. The decision below "gutted" this requirement, and has been criticized on this ground by the leading government contract scholars. *See The A-12 Default Termination: The Mother Of All Terminations*, 13 The Nash & Cibinic Rep., No. 11, p. 166, at 167 (Nov. 1999) ("Nash & Cibinic"). The Federal Circuit sanctioned a "*pro forma*" termination process that will deprive all public contractors of the protections accorded by their contract with the Government, by governing regulations, and by longstanding precedent. If allowed to stand, the decision will fundamentally undermine the stability of Government contracting relationships.

This Court's guidance on this important question is urgently needed, and is appropriate at this time, for several reasons. First, the decision of the Federal Circuit, which will govern virtually all disputes involving contracts with the federal Government, has changed long settled law upon which public contractors rely in calculating the risks and benefits of doing business with the United States. Second, it is highly unlikely

any other Circuit will address the question presented here; the question therefore is ripe for this Court's review.[1/] Finally, review of this issue now is particularly appropriate given the amount at stake in this case. The decision below has reversed a judgment by the trial court entitling these public companies to be paid $1.2 billion in costs they reasonably incurred almost ten years ago, and still have not been paid, and it subjects these companies to a total potential cost forfeiture of over $2.5 billion.

THIS COURT SHOULD GRANT REVIEW TO CONFIRM THE LONGSTANDING REQUIREMENT THAT THE GOVERNMENT MUST MAKE A JUDGMENT ON THE MERITS OF A DEFAULT TERMINATION *PRIOR* TO IMPOSING THAT DRASTIC SANCTION ON A CONTRACTOR.

A. The Government's Extraordinary Power to Terminate Government Contracts Requires Some Procedural Process to Protect Public Contractors.

The Government possesses extraordinary power to terminate its own contractual obligations. Under governing regulations, which are incorporated into virtually all Government contracts, the Government may terminate a contract at any time, for almost any reason, for its own convenience. 48 C.F.R. § 52.249-2(a). When the Government chooses to terminate "for convenience," it is not subject to breach damages, and the only consequence to the Government is that it must reimburse the contractor for the costs the contractor has reasonably incurred

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1/ The Federal Circuit is the appellate court for all contract claims brought against the Government under the Contract Disputes Act. *See* 28 U.S.C. § 1295(a)(3), (10).

to date on the contract, and pay the contractor a reasonable profit on those costs. *Maxima Corp. v. United States*, 847 F.2d 1549, 1552 (Fed. Cir. 1988).

The Government also has the power, under appropriate circumstances, to terminate contracts "for default." *See, e.g.*, 48 C.F.R. §§ 52.249-8, -9. When the Government terminates a contract for default, the consequences for the contractor are severe. *See, e.g., DeVito v. United States*, 413 F.2d 1147, 1153 (Ct. Cl. 1969) (describing default termination "as a species of forfeiture"). The contractor is denied any payment for costs that have not yet been reimbursed *and* it must pay back all progress payments it has received for work that has not yet been completed by the contractor and accepted by the Government. *See* 48 C.F.R. § 49.402-2(a). A default termination also can result in the contractor being debarred from public contracting, *see* 48 C.F.R. § 9.406-2(b)(1), or being prejudiced in the award of new contracts. *See* 48 C.F.R. § 15.304(c)(3).

Thus, simply by terminating a contractor for default, the Government has the power to alter drastically the status quo to the great disadvantage of the contractor. The only way for the contractor to upset this drastic sanction is to bring suit and to sustain the expense of protracted litigation against the Government. In this case, for example, by terminating the A-12 contract for default, the Government sought to impose a cost forfeiture on the contractors of over $2.5 billion, which the contractors have now been challenging in court for over eight years.

By contrast, a default termination benefits the Government. The Government is not only relieved of having to pay the contractor for incurred costs for which the contractor has not yet been paid, the Government also receives back from the

contractor any progress payments that it has made for work that has not yet been completed and accepted. In addition – and the crucial point for purposes of this petition – all that happens to the Government if the contractor subsequently is found by a court *not* to be in default is that the default termination is converted into one for the Government's convenience. *See* 48 C.F.R. §§ 52.249-8(g), -9(g). As noted above, a convenience termination subjects the Government to no penalty: the Government suffers no breach damages and no consequential damages.

In other words, the only consequence to the Government from erroneously imposing upon a contractor the drastic sanction of a default termination is the only other termination choice the Government initially had: a termination for convenience. Without some procedural protection for the contractor prior to a default termination, there is no incentive for the Government to do anything but terminate contracts for default, and force the contractor to contest that drastic sanction in court.

B. Under Longstanding Law, the Standard Government Contract Default Clause Has Required a Judgment on the Merits by the Government.

Given the drastic sanction imposed upon a public contractor by a termination for default, the Government long has been required – at least prior to the decision below – to consider the propriety of a default termination, including a contractor's claims and its explanations for contract performance, prior to terminating a contract for default. This decisional process is required by the standard contract default clause, as interpreted by longstanding precedent, and by governing Federal Acquisition Regulations ("FAR"). If the Government does not

provide the contractor with this procedural protection, the default termination automatically is treated as a termination for convenience. Absent such a requirement – namely, that unless the Government makes a reasoned judgment on the merits *before* subjecting the contractor to the sanctions of a default termination, the termination will be treated *per se* as one for the convenience of the Government – the Government has no incentive to do anything other than terminate for default. *See* Nash & Cibinic, at 167.

Until issuance of the decision below, the Government could not impose the drastic sanction of a default termination without first making a judgment on the merits as to the propriety of that action. This procedural protection for public contractors traces back to at least 1920, when the Federal Circuit's predecessor court, the Court of Claims, vacated a termination for default, stating that "it was incumbent upon the [Government], before exercising the right of forfeiture to be certain of their ground." *Williams Eng'g & Contracting Co. v. United States*, 55 Ct. Cl. 349, 382 (1920). Subsequently, in *John A. Johnson Contracting Corp. v. United States*, 132 F. Supp. 698 (Ct. Cl. 1955), the Court declared a default termination invalid where the contracting officer did not make a "judgment as to the merits of the case." *Id.* at 705. In *Schlesinger v. United States*, 390 F.2d 702 (Ct. Cl. 1968), the Court set aside a default termination because, in connection with the contracting officer's decision to terminate the contract for default, "[t]here was no indication of any concern for the contractor or whether a default would be excusable, no consideration of a possible waiver or an extension, no weighing of a convenience-termination instead of a default-termination." *Id.* at 708-09. *See also Darwin Constr. Co. v. United States*, 811 F.2d 593, 596 (Fed. Cir. 1987) (reaffirming *Schlesinger*); *Lisbon*, 828 F.2d at 765 (recognizing that a default termination "should be

imposed (or sustained) only for good grounds and on solid evidence") (internal quotation omitted).

This "protective rule," *see Schlesinger*, 390 F.2d at 709, is not merely one of judicial creation; it is one of contract interpretation. In *Schlesinger*, the Court held that the standard default clause of a Government contract, like the one in the A-12 contract and all other Government contracts, requires a reasoned exercise of discretion by the Government, *prior* to terminating a contract for default, as to the propriety of a default termination. *Id.* at 707-08[2/] The standard contract default clause requires the Government to undertake this decisional process even if performance problems clearly exist under the contract: in *Schlesinger*, the contractor had missed one contractual delivery date, the Government had issued a letter of warning, and the contractor then missed a second delivery date. 390 F.2d at 704-07. Nevertheless, the Court vacated the default termination because "nobody in the Navy, neither the contracting officer nor his superiors, exercised the discretion they possessed" under the default clause: no one had considered the circumstances of the contractor, whether any default would be excusable, whether any default should be (or had been) waived, or whether the termination should be for default or convenience. *Id.* at 708-09.

In addition to this contractual requirement and its longstanding judicial interpretation, the governing regulations also require that, when a contractor is potentially in default, the contracting officer must make a considered decision on the merits *prior* to terminating for default. The pertinent provisions of the Federal Acquisition Regulations require that,

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2/ The provisions of the default clauses in this case are identical in all material respects to the one at issue in *Schlesinger*. *See* 48 C.F.R. §§ 52.249-8, -9 (contract clauses).

"[w]hen a default termination is being considered, the Government shall decide which type of termination action to take (i.e., default, convenience, or no-cost cancellation) *only after review by contracting and technical personnel, and by counsel, to ensure the propriety of the proposed action.*" 48 C.F.R. § 49.402-3(a) (emphasis added). The regulation further identifies specific factors that "[t]he contracting officer *shall* consider . . . in determining whether to terminate a contract for default." 48 C.F.R. § 49.402-3(f) (emphasis added). Among these factors are "[t]he terms of the contract and applicable laws and regulations" and "[t]he specific failure of the contractor and the excuses for the failure." 48 C.F.R. § 49.402-3(f)(1), (2).

C. Review Is Urgently Needed Because the Decision Below Upsets Settled Expectations Regarding a Public Contractor's Contract Rights.

Contrary to this established law, the only procedural requirement the Federal Circuit's decision imposes for a default termination decision is that there be some "nexus" between the decision to terminate and the contractor's performance. *See* Pet. App. 11a ("In short, *Schlesinger* bars only a termination for default in which there is no considered *nexus* between the default termination and the contractor's performance under the contract.") (emphasis in original); *Id.* at 12a (default termination may be set aside "[w]hen there is no nexus between the decision to terminate for default and contract performance"). All that is required by this "nexus" standard is that "the termination for default [be] predicated on contract-related issues." *Id.* at 2a. This minimal "nexus to performance" requirement is an abandonment of the procedural requirements of the contract clause as interpreted in *Schlesinger*, and it is flatly inconsistent with the governing FAR provisions. If the Government can subject contractors to

the sanction of a default termination simply by asserting some "nexus" between the termination and performance, without even considering substantial issues concerning the legal propriety of that action, the stability of the Government contracting process will be seriously eroded.

A fundamental element of virtually all existing contracts between public companies and the Government has been that the Government owes the contractor a judgment on the merits as to the contractor's legal rights and circumstances prior to terminating it for default. The mere existence of performance issues, including a potential or even apparent default, has not been enough to validate a termination process; rather, the Government has been required to consider questions such as whether the contract requirements have been waived or the Government is at fault for the failed performance. *See Schlesinger*, 390 F.2d at 704-05 (although the contractor failed to deliver by the contractual due date, the default termination was invalid because the Government had not considered whether default was excusable or should be waived); *John A. Johnson*, 132 F. Supp. at 704 (although the contract work was behind schedule, the contractor had requested an extension of time, and "[t]he commanding officer was disgusted with the situation . . . and demanded that the Corps of Engineers terminate the plaintiff's right to proceed," the default termination was invalid because no one in the Government had made a "judgment on the merits of the case"); *Darwin*, 811 F.2d at 594 (default termination was invalid even though the contractor had completed only 65 percent of the required work by the contract delivery date).

The Federal Circuit's decision "gutted" this longstanding procedural protection. Nash & Cibinic, at 167. Public contractors now face the risk of being terminated for default

without the benefit of a reasoned decisionmaking process by the Government as to the propriety of that termination. Gone is the assurance of a pre-termination "[c]onsideration of the merits," which required "review of a contractor's requests for equitable adjustments or excusable delays, whether any government fault was involved, and whether the delivery schedule had been waived." Nash & Cibinic, at 167. The decision below also undermines the procedure mandated by the FAR that the contracting officer obtain "review by contracting and technical personnel, and by counsel, to ensure the propriety of the proposed action," 48 C.F.R. § 49.402-3(a), and consider the factors enumerated in 48 C.F.R. § 49.402-3(f).

Under the Court of Appeals' decision, all the Government must do is merely assert a performance problem, and leave it to subsequent litigation to sort out the validity of that assertion and the applicability of the contractor's defenses. Indeed, the Court of Appeals explicitly sanctioned that approach: "[the contracting officer] meant not to take away the right of Contractors to assert their defenses to termination for default, he instead only meant to assert the government's right to allege material breach on the record of contract performance that had been laid before him by Contractors themselves." Pet. App. 18a. Thus, under the Federal Circuit's new standard, a Government contractor is subject to a termination for default based on a mere "assertion" or "allegation" of default, without any consideration by the Government of the validity of contract claims or defenses that would negate that allegation of default. These claims and defenses are left to the courts to resolve in the first instance – assuming the contractor has the ability to undertake that litigation. *See* Nash & Cibinic, at 167 (if the Federal Circuit's new rule is all that is required, "the Government [will] decide to default terminate in every case and let the contractor have a go at it in litigation"). This shifts the

focal point of decisionmaking from those in the Government most familiar with the circumstances of performance, such as the contracting officer, to the courts, where challenges to ill-founded default terminations will be brought in greater numbers.

This is a radical transformation of Government contracting law. Because the Government has such unique and unilateral power with respect to the contracts it enters, that power always has been, and must be, subject to procedural constraints. If left standing, the Federal Circuit's new standard will benefit no one. It upsets the settled expectations of public companies that do business with the Government, increases their risk and expense from contracting with the Government, and may deter some from doing so at all. And, although the new standard "expand[s] the Government's opportunities for contractual abrogation," it does so "with the certain result of undermining the Government's credibility at the bargaining table and increasing the cost of its engagements." *United States v. Winstar*, 518 U.S. 839, 884 (1996) (plurality).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDICES

APPENDIX A

McDONNELL DOUGLAS CORPORATION,
Plaintiff-Cross Appellant,
and
GENERAL DYNAMICS CORPORATION,
Plaintiff-Cross Appellant,
v.
UNITED STATES, Defendant-Appellant.

Nos. 98-5096, 98-5122, 98-5123.

United States Court of Appeals,
Federal Circuit

July 1, 1999.

Before MAYER, Chief Judge, MICHEL and CLEVENGER, Circuit Judges.

CLEVENGER, Circuit Judge.

This dispute arises out of the government's default termination of a contract between the United States Navy and defense contractors McDonnell Douglas Corporation and General Dynamics Corporation ("Contractors") to develop a carrier-based, low-observable "stealth" aircraft known as the A-12 Avenger. After several years of litigation, the United States Court of Federal Claims held that the government's termination of the contract for default could not be sustained because the government did not exercise the requisite discretion before entering a default termination, *see McDonnell Douglas Corp. v. United States*, 35 Fed. Cl. 358,

368-71 (1996) (hereinafter *McDonnell Douglas IV*), and converted the termination for default into a termination for convenience, awarding Contractors costs totaling $3,877,767,376. *See McDonnell Douglas Corp. v. United States*, 40 Fed. Cl. 529, 555-56 (1998) (hereinafter McDonnell Douglas IX). We hold that, because the termination for default was predicated on contract-related issues, it was within the discretion of the government. Accordingly, the Court of Federal Claims' conversion of the termination for default into a termination for convenience was in error. We reverse the trial court's judgment and remand the case to the trial court for a determination of whether the government's default termination was justified, an issue upon which we express or intimate no view.

I

A

In 1984, the Department of the Navy introduced the Advanced Tactical Aircraft Program, known as the A-12 program, to develop a carrier-based stealth aircraft for the Navy. In January 1988, Contractors entered into a Full Scale Engineering Development contract (the "A-12 FSD Contract") with the government to produce eight FSD aircraft at a target price of $4,379,219,436. *See McDonnell Douglas IV*, 35 Fed. Cl. at 361. The contract was structured as an incrementally funded, fixed-price incentive contract with a ceiling price of $4,777,330,294, and recited a schedule of installment payments over the five- year term of the contract. The first aircraft was originally scheduled to be delivered in June 1990, and subsequent aircraft were to be delivered each month through January 1991. *See id.* at 361-62.

From the outset, Contractors encountered difficulties in performing the contract. Particular problems included meeting the contract schedule and keeping the aircraft weight within specifications. At the beginning of 1990, the Department of Defense initiated a Major Aircraft Review to evaluate various major aircraft programs in view of recent changes around the world and the corresponding reduced threat to national security. *See id.* at 362. The A- 12 program was included in this Review, and Defense Secretary Richard Cheney visited the McDonnell Douglas plant as part of the review process. By the early part of 1990, the Navy's contracting officer knew that Contractors would not meet the delivery date for the first aircraft. *See id.* However, although Secretary Cheney was apprised of some concerns in the A-12 program, the review concluded that there was a continuing need for the A-12 and that the Navy should pursue the program. *See id.* at 363. Secretary Cheney reported these results during his testimony before Congress in April 1990.

In June 1990, Contractors informed the Navy that they could not meet the contract schedule, that the cost of completing the contract would substantially exceed the ceiling price, and that Contractors could not absorb the loss that would result from the contract. Contractors asserted that a fundamental problem with the FSD contract was its structure as a fixed-price contract and proposed that the contract be modified. Thereafter, Contractors submitted a proposal to change the contract schedule, but the Navy and Contractors failed to reach an agreement on that issue. Instead, on August 17, 1990, the Navy unilaterally issued a contract modification that changed the delivery schedule for the aircraft. Under this modification, the delivery date of the first aircraft was delayed until December 1991, and the remaining aircraft became due periodically between February 1992 and February 1993. *See*

Contract Modification P00046 ¶ 1(b), Joint Appendix at 15,657.

In November 1990, Contractors submitted a formal request to the Navy to restructure the contract as a cost-reimbursement type contract. At the end of the same month, two reports were published which documented the handling of the A-12 program under the Major Aircraft Review. The Navy's "Beach Report," dated November 28, 1990, found that the A-12 program manager had been unreasonable both in reaching a conclusion that the contract could be performed within the ceiling price and in evaluating the risk of failing to meet the contract schedule. *See McDonnell Douglas IV*, 35 Fed. Cl. at 363. The Beach Report criticized several Navy officials involved in the A-12 program. Separately, a November 29, 1990 Department of Defense Inspector General report concluded that problems in the A-12 program were inaccurately identified during the Review because the Review did not accord with specified procedures and was otherwise handled poorly. *See id.*

During the Secretary's briefing to the President of the United States in early December 1990, the Secretary indicated his disappointment with the Navy's handling of the A-12 program and promised to take appropriate actions. On December 3, the Secretary directed the Deputy Secretary of Defense to review and report on the status of the A-12 program within ten days. This resulted in several meetings by the Defense Acquisition Board and Defense Procurement Review Boards. In addition, on December 12, the Secretary of the Navy responded to Secretary Cheney's December 3 request with a memorandum that expressed concern about Contractors' ability and willingness to perform under the contract, and which noted in particular Contractors' belief that

the government should assume responsibility for failure to meet goals under the contract, and that the government should restructure the contract. The memorandum concluded with a statement that the Navy would examine whether the contract should be terminated for default, and would make a recommendation to the Secretary by January 5, 1991. *See id.*

On Friday, December 14, Secretary Cheney directed the Secretary of Navy to show cause by January 4, 1991 why the A-12 program should not be terminated. The following Monday, December 17, the Navy issued a cure notice to Contractors stating that unless they were able to meet contract specifications by January 2, 1991, the government might choose to terminate the contract for default. In particular, the cure letter stated that, *inter alia*, Contractors had "failed to fabricate parts sufficient to permit final assembly in time to meet the schedule for delivery," and had "fail[ed] to meet specification requirements." Joint Appendix at 16,524. The letter asserted that "[t]hese conditions are endangering performance of [the] contract." *Id.*

High-level meetings between the responsible government personnel, including the contracting officer and the general counsels of the Department of Defense and of the Navy, and Contractors, including the Chief Executive Officers of McDonnell Douglas and General Dynamics, occurred on December 18 and 21. During these meetings, Contractors asserted that they "[c]an't get there if we don't change contract," *id.* at 16,533, and "[i]t has got to get reformed to a cost type contract or we cannot do it." *Id.* at 16,549. When asked by the government on December 21 "can you correct deficiencies to provide an aircraft that meets the requirements," Contractors replied "[a]ll deficiencies cannot be corrected. Can we deliver a satisfactory aircraft for the

Navy? Mother nature won't allow correction of all defects. We'll do the best we can and the Navy has to decide if that's good enough." *Id.* at 16,548-49.

Contractors responded to the cure notice on January 2 by admitting that they "[would] not meet delivery schedules or certain specifications of the original contract, or the revised FSD delivery schedule." *Id.* at 18,175. Contractors did not contest that they had failed to fabricate parts in time to meet the delivery schedule for the FSD aircraft. Nonetheless, Contractors asserted that they were not in default because, in their view, the delivery schedules were invalid or unenforceable. *See id.* at 18,175-78. As suggested cure, Contractors submitted a proposal to restructure the contract, pursuant to which Contractors would absorb a $1.5 billion fixed loss on the cost overrun from the contract, the contract would be restructured to a cost reimbursement contract, and Contractors would waive their claims for equitable adjustment. Contractors proposed to restructure the contract pursuant to Pub.L. No. 85-804, which gives the President of the United States the power to authorize departments or agencies connected with national defense to grant extraordinary relief under contracts if such an action facilitates the national defense. *See* 50 U.S.C. § 1431 (1994).

On Saturday, January 5, Secretary Cheney met with Undersecretary of Defense for Acquisition Yockey, the Secretary of the Navy, and the Chairman of the Joint Chiefs of Staff to discuss the budget and the A-12 program. At the meeting, Secretary Cheney noted that a scheduled payment of $553 million—one of the largest installment payments under the A-12 contract—was due on Monday, January 7. Later that day, Secretary Cheney, acting under authority pursuant to Pub.L. No. 85-804, decided not to grant relief. On Sunday,

January 6, Undersecretary Yockey informed Rear Admiral William R. Morris, who at this time was acting as contracting officer over the A-12 contract, that Secretary Cheney had denied 85-804 relief and that no further funds would be obligated under the A-12 program. The next day, Admiral Morris issued the termination letter to Contractors stating that the government was terminating the A-12 contract due to Contractors' default.

B

On February 5, 1991, the Navy sent a letter to Contractors demanding the return of approximately $1.35 billion in unliquidated progress payments under the terminated contract. On June 7, Contractors filed suit in the United States Court of Federal Claims under the Contract Disputes Act, 41 U.S.C. § 609(a) (1994), requesting that the court: (1) grant their equitable adjustment claims dated December 31, 1990, (2) convert the government's termination for default into a termination for convenience, (3) deny the government's demand for return of progress payments, (4) award Contractors costs and a reasonable profit under the contract, (5) award them settlement expenses, and (6) award damages for breach of contract. *See McDonnell Douglas Corp. v. United States*, 25 Cl. Ct. 342, 346 (1992).

After several years of litigation in the Court of Federal Claims, that court ruled, in a decision dated April 8, 1996, that the government's default termination was invalid according to *Schlesinger v. United States*, 182 Ct. Cl. 571, 390 F.2d 702 (1968). *See McDonnell Douglas IV*, 35 Fed. Cl. at 368-71. The trial court held that under *Schlesinger*, the government is required to exercise "reasoned discretion" before terminating a contract for default, and that the government failed to meet

this requirement because the Secretary of Defense's actions effectively forced the Navy to terminate the A- 12 contract for default. *See id.* at 369-71. Therefore, the trial court vacated the government's termination for default and converted it into a termination for convenience. *See id.* at 361.

In further litigation over damages, Contractors claimed that they were entitled to recover a reasonable profit under the contract, whereas the government argued that any recovery should be reduced by an appropriate loss- adjustment ratio. Contractors further alleged that the government possessed knowledge regarding how difficult it would be to perform the A-12 contract, and that under the "superior knowledge" doctrine, the government had a duty to either disclose such knowledge or otherwise protect Contractors against suffering unreasonable losses under the contract. The court held that the government's claim for a loss adjustment, Contractors' claim for reasonable profits, and the superior knowledge claim could not be further litigated because of the government's invocation of the "state secrets doctrine," *see McDonnell Douglas Corp. v. United States*, 37 Fed. Cl. 270, 272 (1996) (hereinafter *McDonnell Douglas V*), which grants the Executive the exclusive right to bar discovery into specific classified areas that affect state secrets. *See United States v. Reynolds*, 345 U.S. 1, 7, 73 S.Ct. 528, 97 L.Ed. 727 (1953). The court ultimately denied the government's claim for return of $1.35 billion in unliquidated progress payments, and allowed Contractors total costs under the contract of approximately $3.88 billion. Taking into account progress payments of some $2.68 billion that had already been paid to Contractors, the court entered judgment of approximately $1.2 billion in favor of Contractors. *See McDonnell Douglas IX*, 40 Fed. Cl. at 555-56.

The government appeals from the trial court's decision to convert the default termination to a termination for convenience, and from the trial court's refusal to apply a loss-adjustment ratio in calculating damages. Contractors conditionally cross-appeal the trial court's ruling, arguing that the government has no power to terminate an incrementally-funded contract for failure to make progress toward a goal that has not yet been funded. Contractors also assert that their recovery cannot be reduced by a loss-adjustment factor based on the estimated cost of completing work that was never funded. We have jurisdiction pursuant to 28 U.S.C. § 1295(a)(3).

II

The level of discretion that must be exercised by the government before terminating a contract for default is a question of law, which we review *de novo*. *See Darwin Constr. Co. v. United States*, 811 F.2d 593, 596 (Fed.Cir.1987); *Barseback Kraft AB v. United States*, 121 F.3d 1475, 1479 (Fed.Cir.1997). We will upset the trial court's factual findings, however, only if they are clearly erroneous. *See, e.g., Bass Enters. Prod. Co. v. United States*, 133 F.3d 893, 895 (Fed.Cir.1998).

A

The trial court held that the government's termination of the A-12 contract did not comport with the rule laid down in *Schlesinger* by the United States Court of Claims, our predecessor court, for a proper default termination. *Schlesinger* involved a cap manufacturer who won a contract to supply the Navy with 50,000 service caps for enlisted men. The contract required the manufacturer to submit

pre-production samples of component materials, as well as two samples of the completed cap, to the government for approval prior to production. In addition, the contract included a delivery schedule which set forth delivery dates for five separate installments of the completed caps. *See Schlesinger*, 390 F.2d at 703-04. Schlesinger did not submit the two sample caps and certain thread for pre-production approval, perhaps because he had fulfilled a contract for 240,000 identical Navy caps the previous year. Schlesinger also failed to deliver the first installment of caps as specified in the delivery schedule. *See id.* At the time, Schlesinger was also a prime suspect in an ongoing United States Senate subcommittee investigation regarding textile procurement irregularities within the military. Indeed, Schlesinger testified before the subcommittee during the pendency of his supply contract; shortly after his testimony, the chairman of the subcommittee sent a letter to the Navy implying that Schlesinger's contract should be terminated. This information was communicated to the contracting officer, who promptly terminated Schlesinger's contract. *See id.* at 705-06.

The Court of Claims held that the default termination of Schlesinger's contract was illegal. In doing so, the court first found that Schlesinger was indeed technically in default under the terms of the contract. *See id.* at 706-07. However, the court determined that neither the contracting officer nor anyone else in the Navy exercised independent judgment in terminating the contract for default. *See id.* at 707-08 (citing *John A. Johnson Contracting Corp. v. United States*, 132 Ct. Cl. 645, 132 F.Supp. 698, 704-05 (1955)). Thus, the court found that the contractor's "bare" or "technical" default "served only as a useful pretext for the taking of action felt to be necessary on other grounds unrelated to the [contractor's] performance...." *Id.* at 709.

The illegality in *Schlesinger* stemmed from the Navy's reliance on contractor default as a pretext to terminate its relationship with the contractor, independent of the state of actual performance under the contract. The court characterized Schlesinger's performance shortcomings as merely a "technical default" or "bare default," *id.* at 707, 708, and emphasized the Navy's total failure to consider the level of performance once it found a means for terminating by default. *See, e.g., id.* at 708 ("[T]he Navy acted as if it had no option but to terminate for default ... once the mere fact of non- delivery was found."). In *Schlesinger*, it was improper for the Navy to terminate the contractor for default due solely to pressure from a congressional oversight committee because this ground for termination was totally unrelated to contract performance.

In short, *Schlesinger* bars only a termination for default in which there is no considered *nexus* between the default termination and the contractor's performance under the contract. A second case relied upon by Contractors, *John A. Johnson Contracting Corp. v. United States*, 132 Ct. Cl. 645, 132 F.Supp. 698 (1955), also supports this rule. In *Johnson*, the plaintiff contractor failed to complete construction for Army hospital buildings in a timely fashion because of bad weather that had rendered certain construction roads unusable. The construction roads had previously been contracted out to a different contractor. *See id.* at 699-700. After numerous delays, the contracting officer determined that both the roads and buildings should be completed by a single contractor, and therefore decided to terminate the plaintiff's contract. Although the contracting officer intended to terminate the plaintiff's contract for convenience, he ultimately terminated the contract for default because government lawyers informed

him that a nondefault termination would create legal problems. *See id.* at 705. Because the *Johnson* court found that the contracting officer had already decided to terminate the plaintiff for convenience, it held that the change to a termination for default "did not represent [the contracting officer's] judgment as to the merits of the case." *Id.* Indeed, because the court found, as a factual matter, that the plaintiff could not be held at fault for the unforeseen conditions, *see id.* at 703-04, there could be no proper nexus between a termination for default and the plaintiff's performance.

A third case cited to us by Contractors, *Darwin Construction Co. v. United States*, 811 F.2d 593 (Fed.Cir.1987), further confirms the rule identified above. In *Darwin*, we adopted the Armed Services Board of Contract Appeals's finding that "the default action was taken solely to rid the Navy of having to deal with Darwin." *Id.* at 596 (internal quotation marks omitted). Thus, we held that the government used Darwin's technical default as a mere pretext for terminating the contract on grounds unrelated to performance. *See id.* Furthermore, *Darwin* clarifies what is meant by the "reasonable discretion" test used in *Schlesinger* and *Johnson*. In *Darwin*, we stated that, although a contracting officer has discretion with respect to contract termination, a termination for default will be set aside if it is arbitrary or capricious, or constitutes an abuse of the contracting officer's discretion. *See id.* at 598. When there is no nexus between the decision to terminate for default and contract performance, as was true in *Darwin*, *Schiesinger*, and *Johnson*, the termination for default may be arbitrary and capricious and set aside in favor of a termination for convenience.

Properly understood, then, *Schlesinger* and its progeny merely stand for the proposition that a termination for default that is unrelated to contract performance is arbitrary and capricious, and thus an abuse of the contracting officer's discretion. This proposition itself is but part of the well established law governing abuse of discretion by a contracting official. *See, e.g., United States Fidelity & Guaranty Co. v. United States*, 230 Ct. Cl. 355, 676 F.2d 622, 630 (1982) (listing four factors to be used in determining if conduct by a government official is arbitrary and capricious: (1) evidence of subjective bad faith on the part of the government official; (2) whether there is a reasonable, contract-related basis for the official's decision, (3) the amount of discretion given to the official, and (4) whether the official violated an applicable statute or regulation).

B

The record shows that the government's default termination was not pretextual or unrelated to Contractors' alleged inability to fulfill their obligations under the contract. Therefore, unlike the cases cited above, the government's decision to terminate the A-12 FSD Contract for default was related to contract performance, and the Court of Federal Claims erred by converting the termination into one for convenience without first addressing the question of breach.

First, the trial court interpreted the Navy's actions prior to termination to evince a desire *not* to terminate the A-12 program for default, but rather to continue the contract. *See McDonnell Douglas IV*, 35 Fed. Cl. at 370. For example, the trial court noted that the government had overlooked Contractors' alleged default for several months, had unilaterally modified the contract to excuse the missed

delivery date for the first aircraft, and had determined that even though the aircraft would be overweight, it would still meet operational requirements. *See id.* at 370, 373-74. Moreover, the trial court noted that the Navy "did not contemplate issuing a cure notice in December [1990]" and "did not believe the contractors' performance justified termination." *Id.* at 370.

The trial court's factual findings do in fact establish that the Navy did not want to terminate the A-12 program. Instead, at all times up until the very end, the Navy hoped to preserve the program and its A-12 aircraft. That is not to say, however, that Contractors were not in default under the contract, or that the government did not have the right to terminate the contract for default. A party to a contract, faced with a breach by the opposing party, can choose either to terminate the contract or to continue the contract, perhaps extracting other concessions or consideration from the breaching party in return for its willingness to modify the contract. *See, e.g.*, 3 Samuel Williston & Richard A. Lord, *A Treatise on the Law of Contracts* § 7:36 (4th ed.1992). A party that chooses to proceed with the contract--even if it is the government, and even if it manifests a strong desire to procure the item that is the subject of the contract--does not thereby waive its right to terminate for default. Indeed, the trial court's finding that the Navy went to great lengths to preserve the A-12 program suggests that it would not have terminated the contract but for its belief that Contractors had breached the contract or would not perform the contract.

More importantly, however, the record demonstrates that the government properly terminated the A-12 program for reasons related to contract performance. Admiral Morris, the contracting officer, testified at length about his decisional process that led to the termination for alleged default. He

thought that he had three choices: to terminate for convenience, to terminate for default, or to do nothing. He rejected the latter as "irresponsible," thus focusing his attention on the other two choices. He eliminated the termination for convenience first, because he believed Contractors to be in material breach of the contract. This was so, in his words, because, as conceded in Contractors' response to the cure notice:

> They were in default because they acknowledged they would not be able to achieve the contract specifications and the contract requirements. Two, they had indicated that the would not be able to meet the delivery schedule that was currently in the contract. And three, they would not be able to perform the contract without extraordinary relief or additional funding for the contract. So they basically said they can't perform under the contract and they were in default of it.

Joint Appendix at 3,898-99. In further elaboration of his decision, again in the context of Contractors' response to the cure notice, Admiral Morris testified as to why he thought Contractors' default was material:

> They had failed to fabricate parts so as to endanger performance of the contract, and in my judgment, as would relate to the production options, failed to make progress, and it was clear to me that that is where they stood on the 7th of January when I terminated the contract for default.

Id. at 3,917. As to why a termination for convenience was inappropriate, Admiral Morris stated that:

> [B]ecause I felt very strongly that as a result of the contractors' default, it would be nothing short of unconscionable for me to put the burden of the contractors' failure to make progress and the contractors' failure to fabricate parts, so as to endanger performance of the contract, put that burden on the government and the taxpayer to reimburse all costs and to pay the contractors a profit for their failures.

Id. at 3,920. Therefore, Admiral Morris terminated the contract for failure to make progress and for failure to meet contract requirements.

Failure to meet contract specifications and inability to meet the contract delivery schedule are of course relevant considerations to whether a contractor is in default. *See Discount Co. v. United States*, 213 Ct. Cl. 567, 554 F.2d 435, 441 (1977) (inability to meet specifications); *Universal Fiberglass Corp. v. United States*, 210 Ct. Cl. 206, 537 F.2d 393, 398 (1976) (failure to meet schedule); *see generally* John Cibinic, Jr. & Ralph C. Nash, Jr., *Administration of Government Contracts* 929-35 (3d ed.1995) (discussing the requirements for a default termination based on failure to make progress); *id.* at 953-60 (discussing anticipatory repudiation by a contractor, such as "nonperformance and claims for payments or relief from matters as to which the contractor had assumed the risk").

The trial court also found that Secretary Cheney denied extraordinary relief, which led to the termination, because of concerns about the A-12 program's "cost and schedule." *McDonnell Douglas IV*, 35 Fed. Cl. at 372. The cost to complete a contract—more particularly, the inability of a contractor to perform a contract at the specified contract

price--and the ability to meet a contract schedule are both fundamental elements of government contracts and are related to contract performance; as such, they are highly relevant to the question of default.

The government had specific concerns about when—and if—the A-12 aircraft would ever be delivered and how much it would cost. Secretary Cheney stated in testimony before Congress that the A-12 program was terminated because "no one could tell me how much the program was going to cost even just through the full-scale development phase or when it would be available. Data that had been presented at one point a few months ago turned out to be invalid and inaccurate." *Hearings on National Defense Authorization Act for Fiscal Years 1992 and 1993—H.R. 2100 and Oversight of Previously Authorized Programs Before the House Comm. on Armed Servs.*, 102nd Cong. 60 (1991) (statement of Richard Cheney, Secretary of Defense). The evidence in the record demonstrates that the Secretary of Defense denied relief under Pub.L. 85-804, and Admiral Morris chose to terminate the contract for default, for reasons related to Contractors' state of performance of the contract. The trial court emphasized that although Contractors failed to meet the aircraft weight limit, the Navy essentially waived this requirement because the overweight aircraft would still meet all operational requirements. *See McDonnell Douglas IV*, 35 Fed. Cl. at 363, 376. However, although that finding is relevant to the ultimate determination of whether Contractors were in breach, or whether a breach was excused, it is insufficient to show, in light of all the other evidence in the record, that the government terminated the contract for reasons wholly unrelated to contract performance.

We think it clear beyond any doubt that Admiral Morris, unlike the contracting officer in *Schlesinger*, or in other cases that have upset terminations for default for lack of nexus to contract performance behavior, made his choice for reasons related to contract performance. Admiral Morris certainly knew that Contractors took another view of events transpiring during contract performance: although they admitted that they could not perform the contract according to its terms, they felt that the fault for their failure should be laid at the government's feet. Admiral Morris meant not to take away the right of Contractors to assert their defenses to termination for default, he instead only meant to assert the government's right to allege material breach on the record of contract performance that had been laid before him by Contractors themselves. Given the reasons stated for the action taken by the contracting officer in this case, it was legal error for the trial court to see these facts as commanding conversion of the termination for default into one for the convenience of the government.

To summarize, the government may not use default as a pretext for terminating a contract for reasons unrelated to performance; instead, there must be a nexus between the government's decision to terminate for default and the contractor's performance. The record and the facts found by the trial court establish that the government denied additional funding for the A-12 program and terminated the contract for default because of concerns about contract specifications, contract schedule, and price—factors that are fundamental elements of contract performance. Therefore, the trial court erred by vacating the termination for default without first determining whether a default existed. On remand, if the government can establish that Contractors were in default, then the termination for default would be valid. *See Lisbon*

Contractors, Inc. v. United States, 828 F.2d 759, 765 (Fed.Cir.1987) (holding that the government bears the burden of proof with respect to the issue of whether termination for default was justified). Conversely, if the government is not able to make this showing, then the default termination was invalid and Contractors would be entitled to a suitable recovery, presumably under a termination for convenience theory.

III

We turn next to the government's argument that the trial court erred in refusing to apply a loss ratio to Contractor's termination for convenience recovery, and the trial court's related treatment of Contractors' claims under the superior knowledge theory and for reasonable profits. In government contracts law, under certain circumstances the government owes a duty to disclose critical information to a contractor that is necessary to prevent the contractor from unknowingly pursuing "a ruinous course of action." *Helene Curtis Indus., Inc. v. United States*, 160 Ct. Cl. 437, 312 F.2d 774, 778 (1963). This doctrine of superior knowledge is well established in law, *see, e.g., Hardeman-Monier-Hutcherson v. United States*, 198 Ct. Cl. 472, 458 F.2d 1364, 1371-72 (1972); *Helene Curtis Indus.*, 312 F.2d at 778 & n. 1, and failure to disclose crucial information can lead to a finding of contract breach by the government, *see, e.g., GAF Corp. v. United States*, 932 F.2d 947, 949 (Fed.Cir.1991). In this case, the government resisted Contractors' superior knowledge claims on the ground that the government could not have an implied duty to reveal classified information pertinent to the A-12 program that would threaten national security. The trial court denied the government's motion to dismiss the superior knowledge claims on the pleadings and allowed Contractors

limited discovery. *See McDonnell Douglas V*, 37 Fed. Cl. at 275- 76.

After a series of security breaches and discovery abuses, the trial court concluded that it could not litigate further the related issues of loss adjustment, superior knowledge, and reasonable profits. *See id.* at 272, 276-78. Contractors do not directly appeal this ruling; they contend only that if we upset the trial court's decision on loss adjustment, a remand of all three is appropriate. The government argues that Contractors' superior knowledge and reasonable profits claims were properly removed from litigation because they jeopardized state secrets, but that its loss adjustment claim could be litigated without this danger and should have been allowed to proceed. Because we conclude that the trial court erred in converting the government's default termination of the A-12 FSD Contract to a termination for convenience, whether a loss adjustment applies to termination for convenience damages is not ripe for our decision. Because of the passage of time and of possible intervening developments, we are in no position to judge whether the risk of disclosure of state secrets will preclude adjudication, on remand, of Contractors' superior knowledge claim, and the issues of loss adjustment and reasonable profit. We think the trial court must be free to adjudicate the government's defense of its termination for default in the manner most fair and just to the parties. The trial court thus is free to reconsider this issue on remand. We express no view on the trial court's previous ruling on whether these three interrelated issues may be litigated.

IV

Turning finally to Contractors' cross-appeal, we consider whether the nature of the A-12 contract as a fixed-price, incrementally-funded contract affects the government's ability to terminate the contract. Contractors first argue that the government cannot apply a loss adjustment factor, based on the estimated cost of completing the contract, to Contractor's recovery under a termination for convenience because the government was not obligated to fund the contract to completion. Because we reverse the trial court's conversion of the default termination to a termination for convenience, we do not address this point.

Contractors similarly argue that the government cannot legally terminate the A-12 FSD Contract for failure to make progress toward work that the government was not obligated to fund, and which it in fact did not fund in full. Contractors argue that because the government limited its potential liability to Contractors through the incremental funding arrangement, *see* A-12 FSD Contract, ¶ H-7(c), Joint Appendix at 15,073, there was no mutuality of obligation for the full FSD contract, and the contract was only valid to the extent of the funds already obligated. Under Contractors' theory, it follows that the government could not terminate the contract for failure to make progress toward work that they were not legally obligated to perform. In essence, Contractors assert that the government was precluded from terminating them for default due to failure to make progress toward the completion of the A-12 contract, unless and until the government had funded the contract in full.

We reject Contractors' arguments, however, for the following reasons. First, the A-12 FSD Contract explicitly

recites the grounds upon which the government may terminate the contract for default, which grounds include Contractors' failure to make progress. *See* 48 C.F.R. § 52.249- 9(a)(1)(ii) (1984); A-12 FSD Contract § I ¶ I, Joint Appendix at 15,251 (incorporating FAR 52.249-9). Contractors agreed to installment funding of the contract because the government could not obligate the full ceiling price at the time of contracting. *See id.* § H-7(a), Joint Appendix at 15,072. In order to comply with the Anti-Deficiency Act, *see* 31 U.S.C. § 1341(a) (prohibiting expenditures, obligations, and contracts exceeding appropriations), the parties specified that the government's total obligation, including termination costs, would never exceed the amount obligated at the time of termination. *See* A-12 FSD Contract § H-7(c), Joint Appendix at 15,073. In return, Contractors were not required at any time to incur costs in excess of the total obligated amount. *See id.* § H-7(b), Joint Appendix at 15,072. Despite this funding arrangement, however, the parties agreed that the government had the right to "terminate this contract in whole or in part if the Contractor fails to ... [p]rosecute the work so as to endanger performance of this contract." 48 C.F.R. § 52.249-9(a)(1)(ii) (1984). Therefore, installment funding did not contractually manifest itself as a condition to Contractors' performance; it merely stated a term characterizing the performance of the government. Moreover, the terms of the contract make clear that failure to make progress was a valid basis for default termination.

Second, we disagree with Contractors regarding their obligations under the A- 12 FSD Contract. Contractors emphasize that, because of the incremental funding, there has never been a binding contract for completion of full FSD performance. Contractors acknowledge that the government could have default terminated the contract for failure to meet

specific requirements associated with a particular installment of funding, but assert that failure to meet such specific requirements constitutes the *only* basis for a valid default termination. Because the contract did not link any specific objectives to a particular level of funding, Contractors argue, there was no basis for a default termination. We agree with Contractors that, at the time of termination, they were not obligated to *complete* all contract requirements. That does not mean, however, that Contractors did not have any obligations with respect to the full FSD requirements. As we noted above, the A-12 FSD Contract recites failure to make progress as a basis for contractor default and contract termination. *See* 48 C.F.R. § 52.249-9(a)(1)(ii) (1984). Therefore, Contractors' assertion that failure to meet contract requirements that are linked to already-funded work is the sole basis for default is simply incorrect. Failure to satisfy such requirements forms a ground for default under 48 C.F.R. § 52.249-9(a)(1)(i) (stating that the government may terminate a contract for default if the contractor fails to "[p]erform the work under the contract within the time specified in this contract or any extension"). Subsection (a)(1)(ii), in contrast, provides a separate basis for default: it obligates Contractors to make enough progress so that contract performance is not endangered. *See Universal Fiberglass Corp.*, 537 F.2d at 398 (Ct. Cl.1976) ("Failure to make progress is obviously something different from failure to deliver, or else the default clause would not provide separately for both."). The A-12 FSD Contract makes clear that this is a continuing obligation that exists even though the contract has not yet been funded to completion.

Third, the authorities cited by Contractors fail to establish that they were under no contractual duty to make progress. Contractors rely heavily on an internal government memorandum prepared by the Defense Department's Contract

Finance Committee to support their proposition that a fixed-price incrementally funded contract imposes no obligations on a contractor beyond those associated with funding that has already been provided. The memorandum expresses the committee's view that:

> *[I]f incremental funding is used, the contractor cannot be required to expend any effort beyond the Government's limitation of obligation.* Failure to provide additional funding increments not only results in contract termination, but also makes it necessary to define, after the fact, what part of the effort should have been completed for the amount of funding actually provided. Since this division was apparently not possible in the first place, the contract, for all practical purposes, is converted to a best effort cost-type vehicle; the Government gets whatever the contractor was able to complete with the money provided.... Any advantages gained from use of a fixed price R & D contract are at risk until that point when incremental funding is replaced with full funding.

Memorandum from Chairman, Department of Defense Contract Finance Committee, to Director, DAR Council ¶ 3(c) (June 5, 1992), Joint Appendix at 68,695 (emphasis added). Setting aside questions about the legal significance of this memorandum, we conclude that Contractors' duty to make progress toward completing the A-12 FSD contract is consistent with the views expressed in the memorandum. Unlike the obligation to complete performance, which arises only when the contract has been fully funded, Contractors' duty to make progress is a continuing obligation associated

with each payment installment, and thus is not an "effort beyond the Government's limitation of obligation." *Id.*

Having determined that Contractors were obligated to make enough progress such that contract performance was not endangered, we must now address what progress Contractors should have made, corresponding to the funding actually provided by the government, in order to avoid default for failure to make progress. We disagree with Contractors' argument that it is "not possible" to answer this question, and that the contract must be converted into a cost-reimbursement type contract. *Id.* In litigation over a contractor's failure to make progress--unlike a dispute over failure to meet a specific contract requirement or schedule--courts must always determine *ex post* the threshold of performance that a contractor must meet to avoid endangering performance of a contract. *See* Cibinic & Nash, Administration of Government Contracts 930-32 (tracing the evolution of the test applied by courts for failure to make progress). The same is true in this case.

Contractors rely on *Electronics of Austin*, ASBCA No. 24,912, 86-3 BCA (CCH) ¶ 19,307 (1986), for the proposition that they were under no duty to make progress. In that case, the Board of Contract Appeals found that the government had waived the original contract performance schedule and therefore "there was no time frame within which [the plaintiff] had to perform." *Id.* at 97,631. Because there was "no time frame" at all for performance, the Board held that the plaintiff could not be guilty of failing to make progress. *Id.* In the instant case, however, there was a specified delivery schedule, including the delivery of the first FSD aircraft in December 1991. *See* A-12 FSD Contract § F, Joint Appendix at 15,049 (initial delivery schedule for the eight FSD aircraft); Contract

Modification P00046 ¶ 1(b), Joint Appendix at 15,657 (Aug. 17, 1990) (revised delivery schedule). Therefore, the contract imposed a duty on Contractors to make such progress so as not to endanger performance as long as the contract was in place, that is, as long as the contract was being funded. *See* 48 C.F.R. § 52.249-9(a)(1)(ii) (1984). Consequently, Contractors' protestations to the contrary, we do not "view the contract that existed prior to full funding as embodying the 'ultimate end item' of the full FSED effort." Reply brief of Plaintiffs-Cross Appellants at 6. Instead, we hold only that the contract, throughout its term, embodied a duty to make progress toward the ultimate end item.

The question of whether Contractors satisfied their duty is of course that of breach, and must be determined by taking into account all of the relevant facts and testimony, such as Contractors' statements that they could not meet the contract specifications, the contract delivery schedule, nor complete performance at the specified contract price. *See supra* Part II.B. We leave it to the trial court to resolve these issues in the first instance.

CONCLUSION

We reverse the trial court's ruling that the government's default termination of the A-12 FSD Contract must be converted into a termination for convenience because the government did not exercise the necessary discretion. Of course, we do not hold today that the government's default termination is justified. As Contractors correctly point out, they have never been found to be in default of the contract. Because the trial court focused on the legitimacy of the government's default termination decision, rather than on whether Contractors were in fact in default, the parties have

not yet been afforded the opportunity to fully litigate default. *See McDonnell Douglas Corp. and General Dynamics Corp. v. United States*, No. 91-1204C, slip op. at 2 (Fed. Cl. June 17, 1993). If the government fails to establish at trial that Contractors were in default under the contract, then the government's default termination would be improper and Contractors could rightfully recover damages under the theory of a termination for convenience. We vacate the trial court's ruling that the government's loss adjustment claim and Contractors' superior knowledge claim and claim for profits may not be litigated. Finally, we reject Contractors' argument that the incremental funding found in the A-12 FSD Contract precludes the government from terminating the contract for failure to make progress.

REVERSED-IN-PART, VACATED-IN-PART, AND REMANDED.

APPENDIX B

McDONNELL DOUGLAS CORPORATION and GENERAL DYNAMICS CORPORATION, Plaintiffs,

v.

UNITED STATES of America, Defendant.

No. 91-1204C.

United States Court of Federal Claims.

April 8, 1996.

OPINION

HODGES, Judge.

This case comes before the court after almost five years of litigation regarding the termination for default of the A-12. This opinion sets forth our reasons for vacating the termination for default and converting the termination for default decision to a termination for the convenience of the Government.[1]

Plaintiffs McDonnell Douglas Corporation and General Dynamics Corporation contracted with the Navy to develop a carrier-based, low observable (Stealth) attack aircraft known as the A-12.[2] Defendant terminated the contract for default on

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[1] We adopt the proposed findings of fact issued in the November 5, 1993 Order.

[2] Stealthy characteristics allow aircraft to avoid detection by radar and other forms of observation. The military became very interested in this cutting-edge capability for obvious reasons. The Air Force obtained two

January 7, 1991. Plaintiffs argued that the Navy terminated their contract improperly, and that the contract should be converted to a termination for the convenience of the Government. We tried this part of the case, Count XVII, and later vacated the termination for default:

> Testimony and other evidence at trial showed that the A-12 contract was not terminated because of contractor default. The contract was terminated because the Office of the Secretary of Defense withdrew support and funding from the A- 12. Prior to that, the Navy did not believe that the contractors performance justified termination for default.

McDonnell Douglas Corp. and General Dynamics Corp. v. United States, No. 91-1204C, Order, 1994 WL 715992 (Dec. 9, 1994).

Plaintiffs argued that this ruling meant we must convert the termination to one for convenience of the Government immediately; defendant countered that conversion would create a windfall for the contractors if they were in default without excuses as of January 7, 1991. According to defendant, a "technical violation" in terminating the contract could not justify conversion in light of plaintiffs' alleged "egregious" performance failures. The Navy's failure to exercise discretion in terminating plaintiffs for default was not a technical violation, but we agreed to hear evidence of

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stealth aircraft—the B-2 and the F-117A; the A-12 was the Navy's attempt at this state-of-the-art technology. The harm to national security if this technology were released could be severely damaging, so the A-12 was treated as a compartmented, special access program. The Navy limited access to those individuals with high-level security clearances who had a need to know this information.

plaintiffs' egregious conduct. We converted the termination to default to one for the convenience of the Government in December 1995, upon finding that the Navy was aware of all critical information that could have affected a termination decision.

BACKGROUND

The Navy awarded a full-scale engineering and development (FSED) contract to the McDonnell Douglas/General Dynamics team in 1988 after competition in concept development. The incrementally funded, fixed-price incentive FSED contract had a ceiling price of $4,777,330,294 and a target price of $4,379,219,436.[3] Installment payments were scheduled to be obligated over the five-year contract. The Navy obligated a $185,000,000 installment to the contract on November 1, 1990, and a $553,200,000 installment was scheduled for January 7, 1991.

The contractors were to produce eight FSED aircraft. The contract also provided the Navy an option to purchase four production lots of aircraft. Each FSED aircraft would test different characteristics of the A-12; stealth capabilities would be verified in the "fully capable, fully equipped" eighth aircraft that would serve as the basis for the production lots. Under the original agreement, the first FSED aircraft would be delivered in June 1990; the rest would be delivered monthly through January 1991. The Navy exercised its option on the first production lot on May 31, 1990.

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[3] One member of the other team competing for the FSED contract had produced an Air Force bomber with stealthy characteristics. That team would not agree to a fixed-price contract, and its bid exceeded plaintiffs' bid by more than $400 million.

Three design reviews were held during the contract. An initial design review was completed in May 1988 and the Preliminary Design Review was completed in January 1989. The Critical Design Review process, to begin after the design is essentially complete, began in June 1990.

A. Problems with Performance

The parties were aware of problems in the performance of this contract, namely controlling the growth of the aircraft weight and meeting the contract schedule. Contracting Officer Michael Mutty knew during early 1990 that the contractors would not meet the June delivery date for the first FSED aircraft, yet he took no action to terminate the contract then. When the contractors did not meet the first flight date in June, Mutty noted serious concern regarding performance and asked plaintiffs for an estimate of when the first aircraft would be delivered.

The contractors proposed a new schedule. They asserted claims for changes to the contract, partly due to impossibility of performance and nondisclosure of superior knowledge. The contractors' estimates showed that the projected costs would exceed the contract ceiling price by $324 million. Negotiations on a new schedule were not successful. On August 17, the Navy unilaterally issued contract modification P00046 setting the date for first flight as December 31, 1991. It did not terminate the contract then.

The projected weight was a concern throughout contract performance.[4] The contractors' Best and Final Offer (BAFO) design proposal for the aircraft had indicated a weight empty for the aircraft. At that weight, the aircraft was predicted to meet needed performance characteristics.

Problems in meeting the BAFO weight surfaced around September 1988. The Contracting Officer believed that the contractors would overcome the problems. In late 1989, the CO was concerned that the BAFO weight would not be possible, but he did not issue a cure notice. The Navy believed that the aircraft's other performance characteristics would meet its needs even if the aircraft were not at the originally predicted weight.

In January 1990, the Navy estimated that the aircraft in the first production lot would weigh 7930 pounds over BAFO.[5] The contractors' estimate was less. The Navy obligated the scheduled payment of $1.05 billion that month. The CO did not issue a cure notice.

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[4] This was not an unusual concern for a research and development contract to build an aircraft.

[5] The contractors submitted monthly weight and balance status reports estimating the weight of the eighth FSED aircraft. The reports showed the design or production weight of each part of the aircraft. As the design progressed, the weight assigned to each part could change. The status reports reflected the contractors' current view of the weight; the Navy produced its own estimate based on the contractors' reports and the Navy's assessment of the contractors' commitment to weight-reduction ideas, the technical validity of those ideas, and other subjective conclusions.

B. Major Aircraft Review

The Department of Defense initiated a Major Aircraft Review at the beginning of 1990 to consider its major aircraft programs in light of a diminishing threat and a changing world situation. Its purpose was to decide whether to continue certain programs or to cancel them. The A-12 was included in that review. Secretary of Defense Richard B. Cheney visited the McDonnell Douglas plant in March 1990 as part of the review. There he heard some concerns with production of the aircraft, but he felt fairly confident that the Navy and the contractors could deliver. The conclusions drawn from the review were that the need for the A-12 remained and the Navy should pursue the program. The Secretary reported these results to Congress in April 1990.

Within weeks after his testimony before Congress, the Secretary learned of problems with the A-12. He was informed that the contractors were having schedule and cost problems that would not allow them to perform under the terms of the contract. The Secretary was disturbed by this information because of his recent testimony before Congress. He discussed his concerns with the contractors that summer.

C. Acceptability of the A-12

In July 1990, the Navy sought to revalidate the requirements for the A-12 and to reassess its acceptability at the predicted weight of 7930 over BAFO. The question was whether the increased weight of the aircraft would affect the performance characteristics so that the Navy could not accept the aircraft. The answer was No. The aircraft would be acceptable at the increased weight. The Navy's review concluded that the aircraft would meet all operational

requirements at BAFO plus 7930 pounds, which was NAVAIR's estimate of the weight of the aircraft when the first squadron would be introduced to the fleet. The report stated:

> [I]t has been determined that the A-12 aircraft, despite a projected weight growth of 7930 pounds by IOC, will continue to satisfy Navy operational requirements and is a suitable aircraft for Fleet use....
>
> * * * * * *
>
> The A-12 meets or exceeds all up-and-away performance requirements and, in every instance, exceeds A-6 carrier suitability performance.

The Joint Chiefs of Staff, through the Joint Requirements Oversight Council (JROC), conducted its own review of the A-12 requirements. The November 1990 JROC report stated:

> In all cases, while the operational requirement is still the goal, the predicted performance is a quantum improvement over current capability and is within the operational parameters of the rest of the airwing and satisfies all mission requirements.... There is nothing in these deviations from the original requirement which in the opinion of the JROC affect the fundamental reasons for developing the A-12.

An independent review by the Office of the Secretary of Defense (OSD) concurred that the A-12 program should be pursued. OSD concluded that there was no reason for terminating the A-12 after looking at whether the "technical, schedule, performance, and cost problem risks [were]

sufficiently understood and resolved to warrant continuing the program."

D. Beginning of the End

The Navy obligated $185 million in a scheduled payment at the beginning of November. A $553 million installment payment, one of the largest of the contract, was due on January 7, 1991. Long range budget decisions for Congress were due in January.

At the end of November 1990, two reports regarding the handling of the Major Aircraft Review were published. The Navy's November 28 "Beach Report" found that the Program Manager had been unreasonable in his conclusion that the contract could be completed within the contract ceiling price and that he had failed to anticipate a greater risk to the schedule. Several Navy officials, including the Program Manager, were criticized in the report. A Department of Defense Inspector General report published on November 29 concluded that the nature and extent of the problems with the A-12 were not identified correctly because the review was handled poorly and without following existing control mechanisms.

In his briefing to the President of the United States during the first week of December, the Secretary expressed his disappointment with the Navy's handling of the A-12 and the Major Aircraft Review and promised to "take action to correct the situation." The UnderSecretary of Defense for Acquisition resigned. On December 3, Secretary Cheney stated that there were "serious shortcomings in the program," and he directed the Deputy Secretary of Defense to review the program's status and to report in 10 days.

The A-12 was discussed in a series of meetings in the following days as the Department of Defense decided whether to include certain programs in its budget requests to Congress in January. A Defense Acquisition Board reviewed the A-12 on December 7 and 11, and a Defense Procurement Review Board discussed the A-12 on December 11, 12, and 13.

On December 12, Secretary of the Navy Lawrence Garrett responded to Secretary Cheney's December 3 request for a review of the program. Garrett expressed concerns about the contractors' willingness to perform the contract in accordance with its terms. Secretary Garrett stated: "The Navy also will examine grounds upon which the contract might be terminated consistent with applicable laws and regulations on or before January 5, 1991. We will provide you our views as to whether the program should be terminated for default."

E. OSD Directs Navy to Issue Cure Notice

Secretary Cheney sent a show cause memorandum to the Navy on Friday, December 14.

> The A-12 program is in serious trouble. The apparent schedule slippage, cost growth and management deficiencies in this program are intolerable. If we cannot spend the taxpayers' money wisely, we will not spend it. Accordingly, I direct you to show cause by January 4, 1991 why the Department should not terminate the A-12 program and pursue other alternatives.

The Navy issued a cure notice to the contractors the following Monday, December 17. Neither the Contracting Officer nor the Navy had planned to issue a cure notice; the timing was dictated by the show cause memorandum from Secretary Cheney.[6] In fact, the Department of Defense General Counsel directed the Navy to issue the cure notice and insisted on including language regarding the contractors' failure to meet specifications. The December 17 cure notice stated:

> You are notified that the Government considers your performance ... unsatisfactory. Specifically, you have failed to fabricate parts sufficient to permit final assembly in time to meet the schedule for delivery of FSED aircraft. In addition, you will not deliver the Lot I pilot production aircraft in accordance with the contract schedule. Moreover, your failure to meet specification requirements, such as aircraft weight, jeopardizes the carrier suitability of your design.
>
> These conditions are endangering performance of [the] contract.... Therefore, unless these conditions are cured by 2 January 1991 the Government may terminate for default under the terms and conditions of the default clause of the contract.

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[6] Rear Admiral William R. Morris, the Assistant Commander for Contracts for Naval Air Systems Command, acted as the Contracting Officer during this time. RADM Morris oversaw management issues on thousands of contracts within his office, but he was not involved in daily matters regarding the A-12. He received information on the A-12 from Procurement Contracting Officer Mutty, but he did not know the details of contract performance or the details of the contract specifications. Mutty signed all A-12 documents throughout performance, except for the cure notice and the termination letter.

The Navy believed that the aircraft would meet operational needs, if not all contract specifications. At the time of the cure notice, the contractors had been negotiating with the Navy and Department of Defense officials for financial relief that would call for a restructuring of the contract, both in its terms and its allocation of costs. The Contracting Officer was awaiting the outcome of Secretary Cheney's decision under Pub.L. 85-804 regarding the extraordinary relief.[7] Even if 85-804 relief were not granted, the CO wanted the chance to work out the problems within the existing framework of the contract.

The Office of the Secretary of Defense assumed control over determining whether the A-12 should proceed. OSD directed the Secretary of the Navy not to negotiate with the contractors. The new UnderSecretary of Defense for Acquisition, Mr. Donald Yockey, took charge of negotiating with the contractors. The contractors' financial trouble was his primary concern.

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[7] [T]he President may authorize any department or agency of the Government which exercises functions in connection with the national defense ... to enter into contracts or into amendments or modifications of contracts ... and to make advance payments thereon, without regard to other provisions of law relating to the making, performance, amendment, or modification of contracts, whenever he deems that such action would facilitate the national defense. The authority conferred by this section shall not be utilized to obligate the United States in an amount in excess of $50,000 without approval by an official at or above the level of an Assistant Secretary or his Deputy....

Pub.L. No. 85-804, 72 Stat. 972 (1958). A report justifying those decisions obligating the United States to more than $50,000 must be presented to the President. *Id.*

The contractors submitted certified claims for equitable adjustments on December 31. Those claims requested an adjustment to the contract price and schedule due to superior knowledge and failure of the Government to cooperate during performance. Also on December 31, the contractors requested flexible progress payments to improve their cash flow. The contractors responded to the cure notice on January 2 by disputing that they were in default. They contended that the schedule was invalid and the specifications that allegedly they had failed to meet were unachievable.

Admiral Morris attended a briefing for the UnderSecretary of Defense for Acquisition on January 4. In that meeting, the Chief Engineer for the Navy noted that the operational requirements of the A-12 had been revalidated by the Navy and JROC and that the "technical challenges" that remained were typical for this type of development contract. The Chief Engineer believed that the contractors could overcome the technical problems.

F. Cheney Denies 85-804 Relief

On January 5, a Saturday, Secretary Cheney met with the Secretary of the Navy, the UnderSecretary of Defense for Acquisition, the Navy General Counsel, and the Chairman of the Joint Chiefs of Staff to discuss budgets and the A-12. "And there was also this question of whether or not an additional payment [of $553,200,000] would be made to the contractors on the following Monday," according to Secretary Cheney. The Contracting Officer was not present for this discussion.

Secretary Cheney considered three options: (1) Grant 85-804 relief by providing additional funds and changing the terms of the contract, (2) Direct the contractors to perform, or (3) Terminate the A-12. Cheney understood that the Navy wanted to continue the program and force the contractors to perform according to the terms of the contract. Cheney did not believe that this was reasonable because the contractors had indicated already that they could not meet the current contract.

Other advisers, namely USD(A) Yockey, recommended against both 85-804 relief and the continuation of the program because the contractors were not willing to accept a sufficient loss on the contract. UnderSecretary of Defense for Acquisition Yockey believed that 85-804 would look like a bailout of the contractors. The only alternative Yockey thought appropriate was termination. He wanted to terminate for default immediately, before more funds were obligated.[8]

The Secretary of Defense decided not to grant 85-804 relief. He believed that the natural consequence of his decision not to grant 85-804 relief would be that the program would be cancelled and that the Navy would have to terminate the contract.[9] Cheney was not well-versed in

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[8] Those facts are not in dispute, though we do not know for certain what Mr. Yockey believed. Mr. Yockey did not testify because all of the parties acknowledged that he remembers virtually nothing about the weekend in question.

[9] Secretary Cheney's own perception of his role in the termination of the A-12 was somewhat unclear. He stated repeatedly in court that his decision with regard to the A-12 was only to deny 85-804 relief. The decision to terminate the contract, according to his trial testimony, was left to the Navy.

Q: And in fact, your decision was to terminate the contract for default, isn't that right?

A: My decision was to refuse to grant 85-804 relief, with the expectation of having done that that would lead to the cancellation of the program ..., and ... when I decided not to grant 85-804 relief that meant the end of the program, that the Navy would then be responsible for terminating the contract. And based on everything I had seen up until then, I would have been surprised if they had terminated the contract on any other basis.

In a letter to the President on January 4, 1991, Secretary Cheney focused on his role in assessing the contractors' performance status:

> Although I have not yet made a final decision, we may have little choice but to terminate the contract due to the companies' default on the contract obligations.... If I conclude that it is necessary to terminate the A-12 program due to the contractors' failure to perform, the department will pursue other more affordable approaches.

In testimony before the House Armed Services Committee in 1991, Secretary Cheney stated:

> *The A-12, I did terminate.* It was not an easy decision to make because it is an important requirement that we are trying to fulfill. But no one could tell me how much the program was going to cost, even just through the full-scale development phase, or when it would be available. Data that had been presented at one point a few months ago turned out to be invalid and inaccurate. So after agonizing over it, I made a decision to shut down the program. I think it was the right decision. [Emphasis added.]

Months later before the Senate, Secretary Cheney attempted to clarify his position. He only decided not to grant 85-804 relief, which then led to the termination:

> In terms of killing the A-12, technically what happened--it is

government contracts; he was not aware of the procedure or proper bases for terminating a contract. He did not have a working knowledge of the contractors' equitable adjustment claims or their excuses for alleged non-performance. He did not review the claims of the contractors or the Government. His concerns were limited to cost and schedule. Secretary Cheney informed Secretary Garrett later that day of his decision.

G. OSD Withdraws Support

Admiral Morris was called in to meet with Mr. Yockey and other Defense Department officials at the Pentagon on Sunday afternoon, January 6. Admiral Morris was unaware of the outcome of the meeting that Secretary Cheney had with Navy officials the day before. In fact, Admiral Morris was

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important for the record to reflect this--I made the decision not to come back to Congress to ask for billions more to bail out the contracts for the particular phase of the A-12 program that we were in. The Navy then made the decision to terminate the contract. Technically, that is what transpired.

In his June 30, 1993 deposition, Secretary Cheney apparently took responsibility for the termination for default decision: "The IG has generally done good work for the Department of Defense. I don't always agree with them, but sometimes they produce good results. In this particular case, *they recommended termination for default, which is what I ultimately did.*" [Emphasis added.] Government counsel presented the Secretary with an errata sheet after his deposition. Cheney agreed that government counsel's suggestions of error more accurately reflected what he believed occurred. Government counsel argued that the alteration to the deposition was proper and that the third sentence in the quoted excerpt should read, "In this particular case, *we* recommended termination for default which is what *we* ultimately did." [Emphasis added.] These changes were provided to plaintiffs' counsel the morning of Secretary Cheney's trial testimony.

scheduled to be on vacation that weekend. His plans changed on Friday afternoon when Mr. Yockey required him to attend the Sunday meeting.

Admiral Morris learned from Mr. Yockey at the meeting that Secretary Cheney would not support 85-804 relief, that Mr. Yockey, as the Under Secretary of Defense for Acquisition, could not support continuation of the program, and that Mr. Yockey would not authorize the expenditure or obligation of any more funds to the program. Yockey's decision was clear to Morris: "I, Yockey, as the milestone decision authority, can no longer support the program because of cost, schedule, performance problems, and I will not authorize the obligation of any additional funds for the program."

Admiral Morris argued for the opportunity to resolve the issues without extraordinary relief under Pub.L. 85-804. He thought that discussions with the contractors were not conclusive, and he did not believe that 85-804 relief was the only way of addressing the issues. He sought an opportunity to provide assurances that the program could be sustained. Mr. Yockey repeated that no additional funds would be obligated.

Admiral Morris was stunned by the meeting with Yockey. He had not anticipated termination of the A-12 contract. Soon after the meeting, he told the Navy's service acquisition representative that he probably would terminate the contract for default the following day.

Admiral Morris' disappointment was manifest. He told his wife that evening that "it had been a long, tough day and I hadn't been the winner." He called his immediate

superior, Admiral Gentz, at home and told him the Secretary of Defense would not grant 85-804 relief and that Yockey would not support the program. Morris hoped that Gentz could encourage the "big guns" in the Fleet to make a last-ditch effort to save the program. If not, Morris said he would have to terminate the contract for default the next day.

Admiral Morris wanted to address the problems that he believed led to OSD's decision.[10] He believed that the plane, even with its deficiencies, would do the job. He was not sure of the timing, cost, and whether the Navy would get everything it wanted, but he planned to discuss those matters with the contractors on Monday morning.

Admiral Morris was left with little time to carry out those intentions. A $553 million progress payment was due to the contractors on Monday. On Sunday afternoon, he contacted NAVAIR legal counsel, Margaret A. Olsen, and told her that he was prepared to terminate the A-12 contract for default the next day. He directed her to prepare a termination for default memorandum. She had not anticipated a termination for default on the A-12. She suggested that a termination memorandum from an earlier Navy program, the P-7, be used as a "baseline" for the A-12 memorandum because of the short time frame within which to make the decision.[11]

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[10] Morris "felt the heavy responsibility of doing everything that [he] possibly could do to try to reverse [Yockey's] decision."

[11] The use of a draft memorandum was not unusual. Ms. Olsen used a draft memorandum written by the P-7 procurement contracting officer in developing the final termination memorandum for the file on the P-7. What was unusual is that the draft memorandum used in preparation of the A-12 termination memorandum for the file was not from Contracting Officer

H. Monday Morning Rush

Ms. Olsen began working on the termination memorandum early Monday morning before Admiral Morris arrived. She edited the P-7 termination memorandum on her computer, deleting information that she believed to be peculiar to that contract.[12] Olsen had little information regarding the

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Mutty or from the A-12, but from an entirely different program. Both the A-12 and P-7 were Navy aircraft, but they had distinctly different missions. In fact, defendant attempted to withhold P-7 documents during discovery because the P-7 program was "irrelevant" to this litigation. Admiral Morris and Ms. Olsen had no reservations in relying on this "irrelevant" program for the substance of the termination memorandum for the A-12.

[12] The A-12 termination memorandum includes excerpts from the P-7 memorandum that are not relevant to the A-12. For example:

> Specifically, the team cannot meet the performance requirements of the contract. The team is currently designing the aircraft to have a weight empty 7930 pounds in excess of the guaranteed contract weight empty. *This additional weight precludes the team from meeting contract requirements for takeoff distance, cruise specific range, maximum airspeed and fuel flow, all of which affect mission capability.* [Emphasis supplied.]

The A-12 had no "takeoff distance" requirement because it was a carrier aircraft.

The memorandum focused on the schedule delays in performance, attributing them to the contractors. The paragraph that specifically discussed the amount of delay expected began:

> Since June 1990, the team has consistently reported its delays; and the Navy's independent review confirmed that, given the state of the team's development efforts, delivery of aircraft and completion of related contract requirements could occur no sooner than. [sic]

A-12 at her disposal when preparing the memorandum. She was generally aware of correspondence and conversations that had occurred between the contractors and the Navy. She had not reviewed the contractors' claims, and she had not seen the contractors' response to the cure notice. She directed her staff of attorneys that morning to gather specific information about the A-12. Ms. Olsen did not consult with Admiral Morris about the basis for termination. She did not discuss the termination with the chief engineer, the program manager, or technical personnel.

Morris did not review any A-12 contract documents in preparation for the termination. He did not consult with technical personnel. He did not review the FAR provisions concerning a decision to terminate for default. His review of documents was limited to those related to the weight of the aircraft, and then only to check whether the number "7930" used in the termination memorandum was correct. He did not review documents related to schedule or specifications. Morris approved the termination memorandum at midday after less than an hour of review.

Morris faced three alternatives: terminate the contract for convenience, terminate the contract for default, or continue the contract. Admiral Morris wanted to continue the contract.[13]

The sentence stops short of a prediction, even though the contractors and the Navy discussed estimations earlier in the year. The Navy had told Secretary Cheney that the first flight date was expected in September 1992.

[13] Admiral Morris testified at trial:

> Q: Under [Yockey's] guidelines, you couldn't do the one thing that you wanted to do, what you told him you

He dismissed the option to continue, however, because Yockey would not release the payment due that day. Morris thought that the failure to release the payment would put the Government in breach of contract. He felt that he had no choice but to terminate. Admiral Morris based the termination on the fault of the contractors because he did not believe that the Navy bore any responsibility for the contractors' perceived inability to achieve the contract specifications or deliver the aircraft on schedule. Absent some fault on the part of the Navy, he believed that he could not terminate for convenience because he believed that action would result in a windfall to the contractors.

The termination letter sent to the contractors stated that they were being terminated for default for an "inability to complete the design, development, fabrication, assembly and test of the A-12 aircraft within the contract schedule and the Team's inability to deliver an aircraft that meets contract requirements." The letter stated that the contractors had

> failed to explain or cure those conditions [noted in the December 17 cure notice], and that the Team is in default of the contract for having failed to make progress and not meeting contract requirements. The A-12 aircraft will not be delivered within the contract schedule nor will it meet the weight guaranty contained within the contract specification.

> wanted to do, and that was continue the contract and negotiate with the contractors, correct?
>
> A: That's correct.

DISCUSSION

I.

Default termination is a serious matter. It is a drastic sanction that subjects the contractor to forfeiture. *DeVito v. United States*, 188 Ct. Cl. 979, 990, 413 F.2d 1147 (1969).

The Default Clause of a government contract gives the Government the right to terminate a contract. It does not require that the Government "terminate on a finding of bare default, but merely gives the procuring agency discretion to do so." *Sol O. Schlesinger v. United States*, 182 Ct. Cl. 571, 581, 390 F.2d 702 (1968). This discretion must be exercised and exercised reasonably in a decision to terminate a government contract. 182 Ct. Cl. at 581, 390 F.2d 702; *Darwin Construction Co., Inc. v. United States*, 811 F.2d 593, 596 (Fed.Cir.1987).

The termination clause of the contract cannot be used as a "device" to rid the Government of its contractual responsibilities. That is "an abdication of responsibility which cannot be sanctioned." *Composite Laminates v. United States*, 27 Fed. Cl. 310, 326 (1992) (citing *Schlesinger*, 182 Ct. Cl. at 581, 390 F.2d 702); *see also John A. Johnson Contracting Corp. v. United States*, 132 Ct. Cl. 645, 132 F.Supp. 698 (1955).

Procurement officials must use judgment in deciding whether to terminate a contract for default; they cannot act as "automatons." *Schlesinger*, 182 Ct. Cl. at 581, 390 F.2d 702. If the contracting officer were "improperly influenced by ... anyone else to terminate the contract for default rather than to exercise his own independent judgment in the light of the

factors set out in the regulations, it would represent an abdication rather than an exercise of his discretion." *Fairfield Scientific Corp. v. United States*, 222 Ct. Cl. 167, 182, 611 F.2d 854 (1979). The Government must make its decision on the merits of a contractor's performance, considering alleged defaults as well as excuses therefor. The procurement official must assess all of the relevant circumstances of the contract, and not blindly accept directions from others. *Schlesinger*, 182 Ct. Cl. 571, 390 F.2d 702; *see also Jamco Constructors, Inc.*, VABCA Nos. 3516T, 3271, 94-1 B.C.A. ¶ 26,405 at 131,361-362, 1993 WL 393670 (1993), reconsideration denied, 94-2 B.C.A. ¶ 26,792, 1994 WL 64186 (1994).

The FAR provides valuable guidance for deciding whether to terminate. First, "the Government *shall* decide which type of termination action to take ... only after review by contracting and technical personnel, and by counsel, to ensure the propriety of the proposed action." FAR 49.402.3(a) (emphasis supplied).

> The contracting officer *shall* consider the following factors in determining whether to terminate a contract for default:
>
> (1) The terms of the contract and applicable laws and regulations.
> (2) The specific failure of the contractor and the excuses for the failure.
> (3) The availability of the supplies or services from other sources.
> (4) The urgency of the need for the supplies or services and the period of time required to obtain them from other sources, as compared with the time

delivery could be obtained from the delinquent contractor.

(5) The degree of essentiality of the contractor in the Government acquisition program and the effect of a termination for default upon the contractor's capability as a supplier under other contracts.

(6) The effect of a termination for default on the ability of the contractor to liquidate guaranteed loans, progress payments, or advance payments.

(7) Any other pertinent facts and circumstances.

FAR 49.402-3(f) (emphasis supplied). The Government should consider those factors when deciding whether to terminate for default.[14] Failure to do so is probative evidence that the decision was made precipitously, and without consideration of the relevant circumstances leading to termination for default. *Darwin*, 811 F.2d at 598; *DCX, Inc. v. Perry, Secretary of Defense*, 79 F.3d 132, 135 (Fed.Cir.1996) ("compliance or noncompliance with section 49.402-3(f) may aid ... court in determining" whether termination for default was improperly made); *Lafayette Coal Company*, ASBCA No. 32,174, 89- 3 B.C.A. ¶ 21,963 at 110,482, 1989 WL 74885 (1989) ("Failure to consider one or

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[14] While we emphasize the mandatory language of the regulations, we do not decide this case on that basis. That is, we do not rule that defendant was obliged to consider every FAR factor. Such consideration would have been valuable evidence that defendant did not fail to exercise any discretion. Morris was not permitted to do so. That is the finding of this court: Neither Morris nor anyone else in the Navy was permitted to exercise discretion in terminating this contract.

more of the factors should not invalidate a termination for default where the totality of the circumstances demonstrates a reasonable exercise of discretion any more than mere lip service to the factors should insulate a termination from scrutiny."); *Jamco Constructors*, 94-1 B.C.A. at 131,361 ("The exercise of discretion involves more than a *pro forma* check off of factors drawn from FAR 49.402-3(f).").

The Government's failure to use reasoned discretion when terminating a contract is not a procedural defect that it may correct later. The Court of Claims has refused to sanction such actions. *Schlesinger*, 182 Ct. Cl. at 584, 390 F.2d 702. An improper termination is set aside and the termination for default is converted to a termination for the convenience of the Government. 182 Ct. Cl. at 584, 390 F.2d 702 (proper remedy where the Government abdicates its discretion is to convert the termination for default to one for the convenience of the Government); *see also Darwin*, 811 F.2d at 598 (when a court finds that the contracting officer's default decision was improperly made it will be set aside).

II.

The *Schlesinger* court vacated the termination because it was not issued for contractor default. In that case, "Plaintiff's status of technical default served only as a useful pretext for the taking of action felt to be necessary on other grounds unrelated to the plaintiff's performance...." 182 Ct. Cl. at 583-84, 390 F.2d 702. The Navy and its contracting officer succumbed to pressure to terminate without regard to the circumstances of performance and the contract. In sum, "the Navy simply surrendered its power of choice" in deciding to terminate, and the default termination was improper. *Id.* at

581, 390 F.2d 702. The termination for default was converted to one for the convenience of the Government.

This case is strikingly similar to *Schlesinger*. The procurement in *Schlesinger* was under Congressional scrutiny and there were implications that the contract should be cancelled. Navy officials responded by instructing the contracting officer to terminate the contract if there were no urgent need for the goods. The contracting officer found no urgent need, though the Navy had approved work on the contract until then and had "waived" a missed delivery date only months earlier.[15] With that finding, Navy officials directed the contracting officer to consider the facts and check with legal counsel to determine whether the contract could be terminated for default. When the contracting officer learned that the contractor would not meet the next delivery date, Navy officials instructed him to "[t]erminate contract * * * immediately for default." *Id.* at 578 (so in original).

The Navy could have terminated for convenience, terminated for default, or continued the contract in this case and in *Schlesinger*. Instead, the Navy "acted as if it had no option but to terminate for default (barring all compensation)." *Id.* at 582, 390 F.2d 702. It did not consider excuses for default or whether the termination should be for convenience. Here, and in *Schlesinger*, the agency's actions before termination had not revealed a desire to terminate. The decision to terminate was made hastily without consideration of relevant facts. No one exercised discretion. Both the

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[15] "Waiver" was not vital to the court's decision except to establish that the Navy had overlooked earlier performance inadequacies. Yet, the Navy terminated immediately when the next delivery date was missed. The sudden change in attitude toward the contractor is most important.

contracting officer and the agency felt that they had no choice but to terminate for default.

The Navy's surrender of "its power of choice" in dealing with the A-12 is apparent. It had overlooked the contractors' alleged defaults for months. The contractors missed a delivery date for the first FSD aircraft, and the Government excused it with a unilateral contract modification. The contractors reported that they would not meet the Best and Final Offer weight, and the Government determined that the aircraft still would meet operational requirements.[16]

The contracting officer did not contemplate issuing a cure notice in December. The Navy did not believe the contractors' performance justified termination. The show cause memo from the Secretary of Defense's Office set the wheels in motion. Indeed, OSD directed both the timing and the substance of the cure notice.

The termination of this contract was controlled by OSD's directive to issue a cure notice. Admiral Morris' rush to terminate the contract makes sense only in light of OSD's December 15 show cause letter. Morris had not contemplated issuing a cure notice until the Navy received that directive. No

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[16] This was a research and development contract to provide the Navy with a replacement for the A-6. The Navy wanted an aircraft with the performance characteristics of that plane, but with stealthy capabilities. The "operational requirements" were the goals set for development including performance needs and compatibility with other systems. When the Navy instituted a review of the program to determine whether it wanted to pursue the A-12, it compared the performance capabilities of the A-12 at BAFO plus 7,930 pounds to the operational requirements. The Navy was satisfied that the A-12 would satisfy those goals.

performance- related event prompted the cure notice.[17] The Navy capitulated. The contractors' alleged, long-standing "defaults" served as the excuse for beginning a termination process.

The decision to terminate for default was dictated by the Office of the Secretary of Defense's representations that it would not support the program. Morris could not proceed with the one option that he felt was appropriate--to continue the contract. Admiral Morris and the Navy believed that the aircraft would meet operational requirements. The Navy's actions after the cure notice did not show that it believed the contract should be terminated. Secretary Garrett argued for continuation of performance under the contract at a January 5 meeting. None of the participants except Yockey asserted that the contractors would be unable to develop an aircraft which suited the Navy's operational needs. Yockey's conclusion is insupportable.

The Navy lost all control over the A-12 when the Secretary of Defense's Office took over negotiations with the contractors. OSD's concerns were financial. The contracting officer was left with no discretion whether to terminate the A-12 contract when Mr. Yockey decided that he would no longer support the A-12. In the end, the contract was not terminated because of contractor default. It was terminated because the Office of the Secretary of Defense withdrew support and funding. "[T]he Navy acted as if it had no option

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[17] The NAVAIR weight calculation remained constant throughout 1990 despite contractor indications of possible weight growth. The NAVAIR weights branch could have issued another estimate during the year, but did not. Admiral Morris did not question the weight calculation on January 7 other than to review his files to see if that number was correct. Ms. Olsen did not question that number at the time of termination.

but to terminate for default." *Schlesinger*, 182 Ct. Cl. at 582, 390 F.2d 702.

The contracting officer's use of contractor default was based on his general familiarity with the contractors' performance, which previously he had not believed justified a default termination. He did not consult with technical personnel. He did not review the contractors' claims for equitable adjustments. He could not give adequate attention to the claims that may have excused the alleged defaults in that time, especially those involving superior knowledge issues.[18]

Those individuals who prepared the termination memorandum for the file were not informed by the contracting officer of the chosen grounds for termination. The memorandum was cribbed from another program.[19]

The reasons for default termination thrust upon Admiral Morris were faulty. If plaintiffs were in default, this did not require a termination for default *a priori*.[20] The Government's interests are not necessarily served by such action. A contracting agency must look beyond mere default and consider the interests both of the Government and the

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[18] Information moves slowly in the world of classified, compartmented information. To some it does not move at all.

[19] The Government argues that this is an internal document, and it may be, but the manner in which it was prepared provides evidence of improper termination in the circumstances of this case.

[20] Morris' concern for the public fisc, while admirable, could not be the sole basis for concluding that the contract must be terminated for default, thereby placing the weight of a decision to terminate the program on the contractors.

contractors. If the contractor's defaults are excusable, the contracting officer cannot terminate for default.

This contracting officer preferred alternatives to termination for the reasons contemplated by the FAR. Influences that he could not resist thwarted his instincts. Neither Admiral Morris nor anyone else in the Navy or OSD reviewed the FAR factors in connection with the decision to terminate. Secretary Cheney was not familiar with the FAR; we have no reason to think that Mr. Yockey was. Admiral Morris knew about the FAR inquiries. The termination memorandum shows that consideration of the FAR factors was non-existent. The entire termination procedure was *pro forma* at best.

III.

Nothing in *Schlesinger* justifies a different result here. "Such abdication of responsibility [this court has] always refused to sanction where there is administrative discretion under a contract.... This protective rule should have special application for a default-termination which has the drastic consequence of leaving the contractor without any further compensation." 182 Ct. Cl. at 584, 390 F.2d 702 (citations omitted).

The Navy acted as if it had no choice but to terminate for default in both cases. The reason for the Navy's dilemma does not matter. What does matter is that the reasons were not contractor performance or default.

The *Schlesinger* court did not base its decision on the contracting officer's failure to exercise his own judgment. Neither do we. The power to terminate may rest with "the

Government," but no one in the Government exercised discretion in terminating this contract for default. *Id.* at 583, 390 F.2d 702. Government counsel attempted to distance the Secretary of Defense and his office from the decision to terminate the contract. Their concerns were cost and schedule.

The authority to grant 85-804 relief rests with the Secretary of Defense. The Secretary explained at trial that his action on plaintiffs' 85- 804 application did not amount to a termination of the contract. He testified that his decision was not to terminate the contract, but to deny extraordinary relief to the program.

It does not matter whether the Secretary was correct about the scope or effect of his decision. Secretary Cheney did not review the contract, and he did not consider contractor defaults or any reasons that might have excused those defaults. He did not weigh the merits of different types of terminations or the option of going forward. *See Schlesinger*, 182 Ct. Cl. 571, 390 F.2d 702. Perhaps he could have terminated the contract--we had no reason to address this issue. We did not consider whether Secretary Cheney or anyone in his office could have directed the termination for default because the Government offered no individual or entity other than the contracting officer as the decision-maker. In fact, defendant's witnesses disclaimed such a function during trial. Neither the Secretary of Defense nor anyone else in DOD exercised discretion in the process; no consideration of the contract's circumstances occurred. *See* 182 Ct. Cl. at 584, 390 F.2d 702. If the Secretary did terminate the contract, the reason was not for contractor default.

Defendant argues that the role OSD did play in the termination does not nullify the default termination.

According to defendant, the termination for default was the "direct consequence of a legitimate exercise of OSD's statutory and regulatory oversight authority; [t]hat the discretion of the contracting officer regarding contract continuation may have been obviated by OSD's actions is of no consequence." In effect, defendant argues that the Secretary's authority overrides all contractual obligations of the United States. This argument suggests that most government contracts are illusory.

Defendant contends that *Congress Construction Corp. v. United States*, 161 Ct. Cl. 50, 55, 314 F.2d 527 (1963), *cert. denied*, 375 U.S. 817, 84 S.Ct. 53, 11 L.Ed.2d 52 (1963), supports this notion. The Court of Claims held in that case:

> [W]hen purely executive functions of a discretionary nature are imposed on a subordinate official of the Government it is an implied condition that his actions (before they have become final) are subject to the review and supervision of his superiors--if the superior is authorized to intervene in that particular field and does so in time.

The Court in Congress Construction assumed without deciding that the Navy was "legally bound to plaintiff to make a good faith attempt" to convince Congress that certain properties should be purchased. The purchase was contingent upon congressional approval, and both parties knew it. The Court speculated that some implied duty might have arisen, but there was no contract. Defendant's reliance on Congress Construction is erroneous.

The Secretary of Defense did not want to continue the program. The Navy could have terminated for convenience or

continued the contract upon learning of these views.[21] Admiral Morris did not see this as an option because of the cost to the Government. The Navy used alleged defaults that were longstanding issues between the parties that previously it did not believe justified terminating the contract for default.

IV.

The Navy's less harsh position regarding contract specifications—specifically, weight—during contract performance confirms that the termination for default was improper. The Navy accepted the overweight condition of the aircraft. It was willing to continue. The contractors in fact did continue for months because no one expected them to meet the BAFO estimate. Yet DoD directed the Navy to include "weight" as a basis for termination in the cure notice. That was a pretext.

The Navy knew in September 1989 that the contractors could not meet the weight predicted in their Best and Final Offer. In October, the Navy encouraged the contractors to stop worrying about weight and focus on manufacture and assembly. The Navy did not threaten to issue a cure notice then.

The Navy determined in May 1990 that the weight would be 7930 pounds over BAFO. It knew that the original predicted weight was unachievable. All the parties did. Yet no cure notice was issued or threatened then. Plaintiffs

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[21] As in *Schlesinger*, the termination for convenience clause "could have been used to end performance if the Navy thought it well to do so on learning of the Senate committee's views." 182 Ct. Cl. at 584, 390 F.2d 702.

pursued weight reduction programs vigorously at the Navy's request. No one thought that the contractors would meet the BAFO weight. The Navy's and the contractors' concern was that the weight not continue to increase. "7930 pounds over BAFO" was the benchmark for weight-reduction efforts.

The contractors notified the Navy on June 13 that they could not meet the BAFO estimate. They requested a revision of the contract. This letter documents the contractors' belief that the BAFO weight had been waived. While the BAFO weight still was in effect, no one believed that it could be achieved. The Navy only wanted an aircraft that could meet its operational needs. The contractors continued to perform.

At termination, the Navy had known for at least eight months that the contractors could not meet the BAFO weight, and the Navy accepted it. Its strategy was to maintain the original contract until the end, then exact consideration for the contractors failure to meet the BAFO weight. It did not want to put the contractors in default.

The contractors relied on the Navy's directions to continue performance despite their failure to meet the BAFO weight. The Navy wanted an aircraft that would meet its operational needs, and plaintiffs design did so at 7930 pounds

overweight.[22] In response, the contractors no longer strived to meet BAFO weight.

The weight remained stable throughout 1990 according to the Navy, although there were indications from the contractors of potential weight increases. The Navy pressured the contractors during the summer of 1990 to keep the weight growth under 8000 over BAFO. An extra 70 pounds could not have caused great problems with carrier suitability or the Navy's satisfaction with the aircraft's projected performance.[23]

The Navy and the A-12 were under intense scrutiny during the spring and summer of 1990. The Major Aircraft Review had been a disaster, and Secretary Cheney was concerned. One concern was a perceived inability of the contractors to control the weight growth. Weight growth of an aircraft is not unusual in a research and development program, and weight control always has tradeoffs. The tradeoffs in this instance were acceptable. It was the *appearance* of the inability to control the weight growth that was more damaging to the Navy than the qualitative effects of more weight.

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[22] The 7930 figure was the subject of much debate. As discussed earlier, the 7930 estimate was a government number derived from the contractors' monthly weight and balance status reports. From those reports, the Navy assessed the contractors' commitment to certain weight reduction ideas, analyzed the technical validity of those ideas, and made other subjective conclusions. Throughout 1990, the contractors' estimate was almost 1000 pounds less than the Navy number. The Navy's estimate was no more authoritative than the contractors' numbers. The Navy's assessment of carrier suitability would not necessarily have changed with a higher estimate.

[23] The "strike weight" of the aircraft was 79,000 pounds.

The Navy obligated payment in the fall of 1990, knowing the limitations of the contractors' weight control efforts. At termination, Admiral Morris and NAVAIR had not changed their weight projections for at least a year. The Navy was willing to go forward with the aircraft in that condition and it allowed the contractors to continue performance with that understanding. It was not included in the cure notice until the Department of Defense General Counsel so directed. The Navy cannot support the inclusion of weight in the cure notice as a reason for termination.

V.

A. Post-Hoc Justifications

A termination for default may be justified at trial on other grounds in some circumstances, if the Government exercised discretion in terminating the contract. *See, e.g., Pots Unlimited, Ltd. v. United States*, 220 Ct. Cl. 405, 600 F.2d 790 (1979) (citations omitted) ("[I]t is settled law that a party can justify a termination if there existed at the time an adequate cause, even if then unknown."). For example, if the contracting officer makes a discretionary decision to terminate, but does so for the wrong reason, the termination may be upheld. However, the reason used must have been a non-curable one, so that the contractor would not be prejudiced by the lack of a cure notice. *See College Point Boat Corp. v. United States*, 267 U.S. 12, 45 S.Ct. 199, 69 L.Ed. 490 (1925); *Pots Unlimited*, 220 Ct. Cl. 405, 600 F.2d 790 (violation of contract provision that prohibited sales of pottery on the property); *Joseph Morton Co. v. United States*, 3 Cl. Ct. 120 (1983), aff'd, 757 F.2d 1273 (Fed.Cir.1985) (contractor fraud unknown at time of termination); *Quality Granite Construction Co., Inc.*, ASBCA No. 43846, 93-3

B.C.A. ¶ 26,073, 1993 WL 169822 (1993), *aff'd on reconsideration*, 94-1 B.C.A. ¶ 26,430, 1993 WL 409998 (1993), *aff'd*, 26 F.3d 138 (Fed.Cir.1994) (termination for default proper for violations of Davis-Bacon Act unknown at time of termination); *Samuel T. Isaac & Associates, Inc. v. United States*, 7 Cl. Ct. 255 (1985) (criminal conduct unknown at time of termination); *Kelso v. Kirk Bros. Mechanical Contractors*, 16 F.3d 1173 (Fed.Cir.1994) (violations of Davis-Bacon Act unknown at the time of termination may subsequently support termination for default).

A cure notice places the contractor on notice of performance deficiencies that the Government believes will endanger the successful completion of the contract.[24] The cure notice allows the contractor to argue that the deficiencies are excused, or to provide reasonable assurances that the problems can be overcome. Thus, a termination for default is improper if the reasons stated for termination are different from the reasons given in the cure notice. *See generally Composite Laminates v. United States*, 27 Fed. Cl. 310 (the contractor must be on adequate notice of the reasons for default termination for the termination to be proper). The Government may not propose reasons for default at trial that the contractor might have cured had it been on notice of the problem during contract performance. The "post hoc" justification exception is limited to those circumstances in which the cure notice could not have been a factor; *i.e.*, where the reason asserted at trial was non-curable.

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[24] If a termination is predicated upon a failure to make progress so as to endanger performance, "the contracting officer shall give the contractor written notice specifying the failure and providing a period of 10 days (or longer period as necessary) in which to cure the failure." FAR 49.402- 3(d).

The contracting officer did not use discretion in deciding whether to terminate the contract. Then, the contracting officer abandoned its remaining opportunity to consider whether the contract should be terminated for default. If he had used discretion, a post hoc justification might have been acceptable because a court would have had the benefit of the contracting officer's review of the FAR factors and other considerations that justified termination for default. *See Spread Information Sciences, Inc.*, ASBCA No. 48,438, 96-1 B.C.A. ¶ 27,996, 1995 WL 592785 (1995).

This contract was not terminated for contractor default. We do not have the benefit of a reasoned decision. We do not know what action the contracting officer would have taken had he been permitted to exercise judgment.[25] A termination decision "issued improperly [without the exercise of discretion] ... cannot have the same status as a default-termination which is the fruit of true consideration." *Schlesinger*, 182 Ct. Cl. at 584, 390 F.2d 702.

Contractor default need not end in termination. The Government commonly elects not to terminate a contract that is in technical default, instead granting an extension or contract modification, or waiving the non- compliance. 182 Ct. Cl. at 581, 390 F.2d 702. The question remains whether there would ever be a sufficient reason in light of the Government's failure to exercise discretion for which the contractor should withstand the harsh result of a default termination, especially where the reason is given first during litigation. *See Walsky Construction Company (II)*, ASBCA No. 41,541, 94-2 B.C.A. ¶ 26,698 at 132,784, 1994 WL 43415

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[25] Although we do know that this contracting officer's desire was to continue the contract.

(1994) (where the Government abused its discretion in terminating for default, the Board stated: "Assuming, arguendo, that a different technical ground for default, not relied upon by the contracting officer, was established, it would not affect the outcome of this case.").

B. Bare or Technical Default

The *Schlesinger* court agreed that the contractor was in bare or technical default at the time of termination.[26] Even so, the termination for default could not stand: "[T]he default article does not *require* the Government to terminate on finding a bare default but merely gives the procuring agency discretion to do so, and that discretion was not exercised here by the Navy." 182 Ct. Cl. at 581, 390 F.2d 702 (so in original). The court converted the termination for default to one for the convenience of the Government.

The Court's use of the words "technical" and "bare" in *Schlesinger* to describe default in the circumstances of that

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[26] That case uses the terms repeatedly. "As the Board found, plaintiff was at least in technical default when his contract was terminated on July 1st. He was required to deliver 15,000 caps by June 30th and did not do so." 182 Ct. Cl. at 580, 390 F.2d 702. "Our difficulty is that the default article does not require the Government to terminate on finding a bare default but merely gives the procuring agency discretion to do so, and that discretion was not exercised here by the Navy." *Id.* at 581, 390 F.2d 702 (so in original). "We are certain that there have been a great many instances in which the Government has not terminated a contractor in technical default, but has granted an extension or waived the non-compliance." *Id.* at 581, 390 F.2d 702.

case is important and appropriate.[27] The contractor missed a delivery date, and although the product was in production, the Government used that default as an excuse for escaping an unwanted contract.

The contracting officer may decide that a contract should be terminated upon finding the contractor in default. Thus, the Government has the legal right to operate under the default clause for contractor shortcomings, but the court will not allow it to terminate for default when that default is pretextual.

Much of the termination decision depends on the nature of the performance problems, expectations of the outcome, whether the Government will receive its needs even if not within specifications, and other considerations that properly are left to the procuring agency.[28] A technical or bare default may result more often than not in a continuation of the contract. 182 Ct. Cl. at 581, 390 F.2d 702. It may be economical for the Government to receive goods late or

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[27] These terms are not found in the FAR, but their plain meaning evokes certain images. *Technical* means "marked by a strict legal interpretation," *Webster's New Collegiate Dictionary* 1196 (1977), or "concerned with or making use of technicalities or minute, formal points." *Webster's New World Dictionary* 1373 (3d. ed. 1988). Bare means "without embellishment; unadorned; simple; plain" or "no more than; mere." *Webster's New World Dictionary* 110.

[28] Contracting Officer Mutty indicated that the excess weight did not necessarily constitute the grounds for issuing a cure notice: "There are other performance requirements under the contract. You'd have to look at whether or not they were going to meet some of the other performance requirements ..." and "I guess it would depend on the degree to which it was going to be overweight, but just because it would be overweight, no, we would not automatically terminate."

slightly off specification than to reprocure or to go without. DeVito, 188 Ct. Cl. at 990, 413 F.2d at 1153 (stating that the Government is much more interested in production than in litigation).

The extent of the default may affect a contracting officer's decision whether to continue the contract. The greater and more extensive the problems, the less likely it is that a contracting officer would choose to continue the contract. In such circumstances, a termination for default is more likely. The FAR factors might provide reason to continue the contract or take other action. But that decision is one for the contracting officer and the agency to make.

At some point, default could be so extraordinary or egregious that the Government would have no choice but to terminate. Application of discretion would be superfluous because any rational contracting officer would be compelled to terminate for default.[29] At this extreme, any other decision

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[29] Defendant argued in January 1995 that the Government had a "right to demonstrate that plaintiffs' overwhelming performance failures and defaults, including their repudiation, were material and unexcused, and that they fully justified, *if not required*, the Government's decision to terminate the contract for default." [Emphasis supplied.] In addition, "Plaintiffs apparently contend that they are entitled to the windfall of their convenience termination costs regardless of the actual *egregiousness* of their performance failures...." At a hearing, the Government pleaded that "if the default was, as we believe occurred here, *egregious and overwhelming*, then the ... violation could not have any impact on the decision to terminate for default. In other words, if the default is *so overwhelming*, it's a harmless error problem because *no reasonable contracting officer could have decided to ignore that default*." [Emphasis added.] The term "egregious" connotes a harshness appropriate in the circumstances of this case. Indeed, only the most outrageous and flagrant of defaults could absolve the government of its wrongful termination. Defendant indicated in May 1995 that it intended to prove that the

by the contracting officer could be an abuse of discretion.[30] Thus, a termination imposed without the benefit of reasoned discretion could be upheld only if contractor performance were so deficient that termination for default was the only possible result.

Facts known to the Navy at the time of termination constituted no more than a technical or bare default, if that. Morris believed that the contractors were in technical default at the time of termination:

> It was my belief that the contractors were technically in default of the contract, and basically, given the choices that I had, termination for convenience, termination for default, or do nothing, given the fact that I did believe they were in technical default of the contract, it would be irresponsible of me thereto to have the taxpayers and the Government pay for the adjudication of a situation where the contractors, through their failure to perform, had caused the default.

Everyone agreed that the plane would not meet the BAFO weight. The amount of excess was of little importance; the plane was still expected to meet all "operational requirements." There is no indication that any amount of weight growth would have changed the Navy's position. The

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contractors' failure to disclose pertinent information regarding current and projected performance would amount to egregious default.

[30] We told the parties before trial on Count XVII that defendant would have the chance to prove that "the contractors' performance was *so deficient* that a decision to terminate this contract on that basis would have been reasonable." June 17, 1993 Order (emphasis added).

contracting officer could have terminated the contractors for such problems, but he could have continued the contract and exacted consideration. The Navy was aware of all critical information it needed to make this decision.

Defendant asks us to uphold the termination for reasons that the Navy had at its disposal but did not believe justified termination for default until OSD withdrew funding. Left to its own devices, the Navy would have continued the contract in the face of such deficiencies. The Navy was not permitted this option because of OSD's action.

C. Anticipatory Repudiation

Defendant contends that the contractors repudiated this contract by their repeated failure to provide adequate assurances when requested, and by their indications that they would not perform the contract. Defendant asserts that repudiation is an absolute defense to the wrongful termination irrespective of whether it was asserted at termination.

A contracting officer may terminate a contract for default when there has been a "positive, definite, unconditional, and unequivocable manifestation of intent ... not to render the promised performance when the time fixed ... by the contract shall arrive...." *Cascade Pacific International v. United States*, 773 F.2d 287, 293 (Fed.Cir.1985) (quoted in *United States v. Dekonty Corp.*, 922 F.2d 826, 828 (Fed.Cir.1991)). Refusal to perform may be evidenced by word or deed, but it must show that the party "absolutely refuses to perform his contract, and before the time arrives for performance distinctly and unqualifiedly communicates that refusal to the other party...." *Dingley v. Oler*, 117 U.S. 490, 499, 6 S.Ct. 850, 29 L.Ed. 984 (1886).

The contractors did not portray a *positive, definite, unconditional*, and *unequivocal* refusal to perform. The Government did not view any of their actions in this manner; no reasonable party to a contract could have. The parties were engaged in various ongoing disputes over the contract. The contractors made clear to the Navy their difficulties with the contract, and the Navy acknowledged them in many respects. Nonetheless, the contractors continued to perform. Negotiations regarding a specific avenue of relief failed. The contracting officer did not believe that the contractors would not perform; he wanted to continue the contract and address the issues with the contractors without extraordinary relief. That avenue was blocked by the Secretary of Defense, not by

the contractors.[31] The contractors did not repudiate this contract.[32]

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[31] Defendant argues that Admiral Morris hoped that he "could have" negotiated a solution under the contract, implying that the contractors' repudiation prevented this. In fact, Morris could not pursue this because of OSD, not because of the contractors. Morris testified:

> I sought authority at the meeting on the 6th to attempt--my specific thrust was that even though the Secretary had determined that he would not support extraordinary relief under Public Law 85-804, I wanted the authority and permission to try to negotiate a resolution of the issues within the boundaries of the contract, without any extraordinary relief. Again, this was our top priority program, I didn't know whether I would be successful at doing that, but given the fact it was so important to the Navy, I wanted to give it a try, and—... I did not personally think that the only possible way out of this was extraordinary relief....
>
> I persisted and asked again that I be given an opportunity. [Yockey] heard me out, he considered it, and he reaffirmed for me that he no longer supported the program and that there would be--he would not authorize the release of additional funds.

[32] Anticipatory repudiation might qualify as a *post hoc* justification if it had occurred because a cure notice would not have been necessary.

> [W]henever there is a positive, definite, unconditional, and unequivocal manifestation of intent ... not to render the promised performance when the time fixed therefor by the contract shall arrive, the contracting officer is not required to go through the useless motions of issuing a preliminary "10-day cure" notice even though the time for performance has not yet arrived, but may terminate forthwith on the ground of anticipatory breach.

Mission Valve and Pump Co., Div. of Mission Mfg. Co., ASBCA Nos. 13552, 13821, 69-2 BCA ¶ 8010 at 37,243, 1969 WL 718 (1969). Defendant indicated in hearings in preparation for trial in 1995 that it did not have evidence in addition to that presented in the Count XVII trial to support anticipatory repudiation. *See* September 14, 1995 Order.

CONCLUSION

The decision terminating the contract for default was not proper. This is not a case about the authority of the Secretary of Defense to cancel contracts or programs. The A-12 contract was not terminated because of contractor default. The contract was terminated because the Office of the Secretary of Defense withdrew support and funding from the A-12. Prior to that, the Navy did not believe that the contractors performance justified termination for default.

APPENDIX C

MCDONNELL DOUGLAS CORPORATION, Plaintiff-Cross Appellant,

and

GENERAL DYNAMICS CORPORATION, Plaintiff-Cross Appellant,

v.

UNITED STATES, Defendant-Appellant.

98-5096, 98-5122, 98-5123

UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

October 29, 1999, Filed

ORDER

A combined petition for rehearing and suggestion for rehearing en banc having been filed by the CROSS-APPELLANTS, and a response thereto having been invited by the court and filed by the APPELLANT, and the petition for rehearing having been referred to the panel that heard the appeal, and thereafter the suggestion for rehearing en banc and response having been referred to the circuit judges who are in regular active service,

UPON CONSIDERATION THEREOF, it is

ORDERED that the petition for rehearing be, and the same hereby is, DENIED and it is further

ORDERED that the suggestion for rehearing en banc be, and the same hereby is, DECLINED.

The mandate of the court will issue on November 5, 1999.

Circuit Judge SCHALL, and Circuit Judge BRYSON did not participate in the vote.

Dated: October 29, 1999

APPENDIX D

48 C.F.R. § 49.402-3

49.402-3 Procedure for default.

(a) When a default termination is being considered, the Government shall decide which type of termination action to take (*i.e.*, default, convenience, or no-cost cancellation) only after review by contracting and technical personnel, and by counsel, to ensure the propriety of the proposed action.

* * *

(f) The contracting officer shall consider the following factors in determining whether to terminate a contract for default:

(1) The terms of the contract and applicable laws and regulations.

(2) The specific failure of the contractor and the excuses for the failure.

(3) The availability of the supplies or services from other sources.

(4) The urgency of the need for the supplies or services and the period of time required to obtain them from other sources, as compared with the time delivery could be obtained from the delinquent contractor.

(5) The degree of essentiality of the contractor in the Government acquisition program and the effect of a termination for default upon the contractor's capability as a supplier under other contracts.

(6) The effect of a termination for default on the ability of the contractor to liquidate guaranteed loans, progress payments, or advance payments.

(7) Any other pertinent facts and circumstances.

* * *

(j) If the contracting officer determines before issuing the termination notice that the failure to perform is excusable, the contract shall not be terminated for default. If termination is in the Government's interest, the contracting officer may terminate the contract for the convenience of the Government.

* * *

48 C.F.R. § 52.249-8

52.249-8 Default (Fixed-Price Supply and Service).

As prescribed in 49.504(a)(1), insert the following clause:

DEFAULT (FIXED-PRICE SUPPLY AND SERVICE) (APR 1984)

(a)(1) The Government may, subject to paragraphs (c) and (d) below, by written notice of default to the Contractor, terminate this contract in whole or in part if the Contractor fails to —

(i) Deliver the supplies or to perform the services within the time specified in this contract or any extension;

(ii) Make progress, so as to endanger performance of this contract (but see subparagraph (a)(2) below); or

(iii) Perform any of the other provisions of this contract (but see subparagraph (a)(2) below).

* * *

(g) If, after termination, it is determined that the Contractor was not in default, or that the default was excusable, the rights and obligations of the parties shall be the same as if the termination had been issued for the convenience of the Government.

* * *

48 C.F.R. § 52.249-9

52-249-9 Default (Fixed-Price Research and Development).

As prescribed in 49.504(b), insert the following clause:

DEFAULT (FIXED-PRICE RESEARCH AND DEVELOPMENT) (APR 1984)

(a)(1) The Government may, subject to paragraphs (c) and (d) below, by written Notice of Default to the Contractor, terminate this contract in whole or in part if the Contractor fails to —

(i) Perform the work under the contract within the time specified in this contract or any extension;

(ii) Prosecute the work so as to endanger performance of this contract (but see subparagraph (a)(2) below); or

(iii) Perform any of the other provisions of this contract (but see subparagraph (a)(2) below).

* * *

(g) If, after termination, it is determined that the Contractor was not in default, or that the default was excusable, the rights and obligations of the parties shall be the same as if the termination had been issued for the convenience of the Government.

* * *